

Commercial Environment

Overview

The commercial environment is challenging...

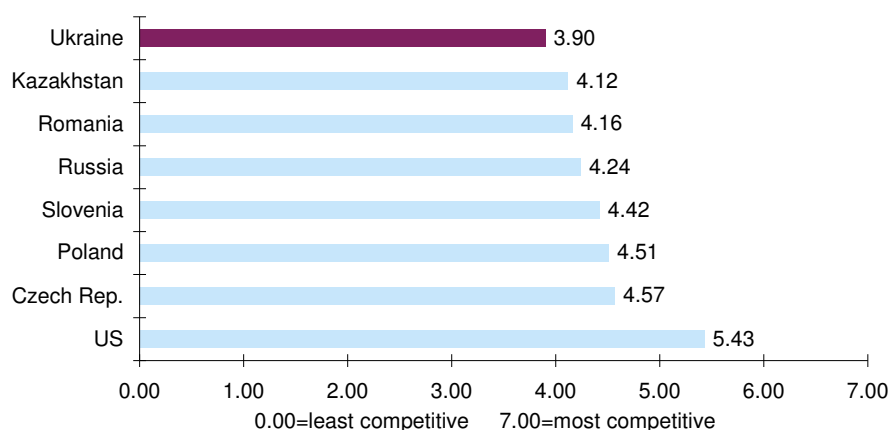
The commercial environment in Ukraine is challenging. The physical infrastructure is relatively well-developed but the rule of law is weak, corruption endemic and the protection of intellectual property rights insufficient. Policies and legislation frequently change with (in some cases) different laws contradicting each other. The tax system is one of the most onerous in the world, and the OECD has noted both an excessive regulatory burden and poor regulatory processes, which create high barriers to entry, exit and reallocation of capital and labour. As in almost all former communist countries, the institutions underpinning the market-based economy remain under-developed. In Ukraine, this is exacerbated by a lack of effort in improving the business environment. The weak domestic political outlook (see **Domestic Politics**, p6) makes it unlikely that the commercial environment will improve significantly in the near future.

Reflecting the weakness of the commercial environment, the World Bank's *Doing Business 2011* survey ranks Ukraine a poor 145 out of 183 countries in the overall ease of doing business. The World Economic Forum's *Global Competitiveness Report 2010/11* ranks Ukraine at 89 out of 139 countries, although this masks very poor performances, for example with respect to judicial independence (ranked 134), property rights protection (135), and the quality of the legal framework to settle disputes (138) and challenge regulations (138).

...despite WTO accession in 2008

WTO accession in 2008 brought some improvements, but its direct impact should not be overestimated. Most of the legal changes required by WTO membership were enacted during the accession process, thereby limiting the impact of accession itself, while the extremely poor business environment of many members shows that WTO membership is not a panacea.

Relative Competitiveness, 2010-11



Source: World Economic Forum, *Global Competitiveness Report*

Physical Environment

Natural Environment

With an area of more than 600,000 square kilometres, Ukraine is the second-largest European country west of Russia, slightly smaller than France. The country is located on the north shore of the Black Sea, between Russia and the EU. Fertile plains (steppes) and plateaus make up most of its territory, and the climate is mostly temperate continental, with cold winters and warm summers. Winters are milder and summers hotter along the Black Sea coast and in the Crimea.

The country remains among the world's main exporters of grain and other agricultural produce. Ukraine's natural resources also include: iron ore and other metals; deposits of coal, oil, natural gas and further minerals; and timber. There are no major natural hazards that pose a threat to business activities.

Infrastructure

The infrastructure is relatively well developed

Ukraine boasts an extensive and relatively well-developed infrastructure, although large parts of it are outdated and/or in need of major upgrades. Commercial and passenger transportation occurs via roads, railways, air and waterways. The main international airport is at Kiev. The main ports are Kerch, Odessa and Sevastopol on the Black Sea, as well as Kiev (on the Dnieper River) and Reni (on the Danube, close to the Black Sea). Thanks to its location between Russia and the EU and on the shore of the Black Sea, three of ten major pan-European transport corridors run through Ukraine.

In its *Global Competitiveness Report 2010/11*, the World Economic Forum ranks Ukraine 68 out of 138 countries in the quality of the infrastructure. According to the report, the major disadvantage is the quality of roads (rank 136) and air transport infrastructure (110). By contrast, Ukraine compares relatively favourably in the quality of railway infrastructure (25), the level of mobile telephone subscriptions (34) and the availability of fixed telephone lines (47).

Legal and Regulatory Environment

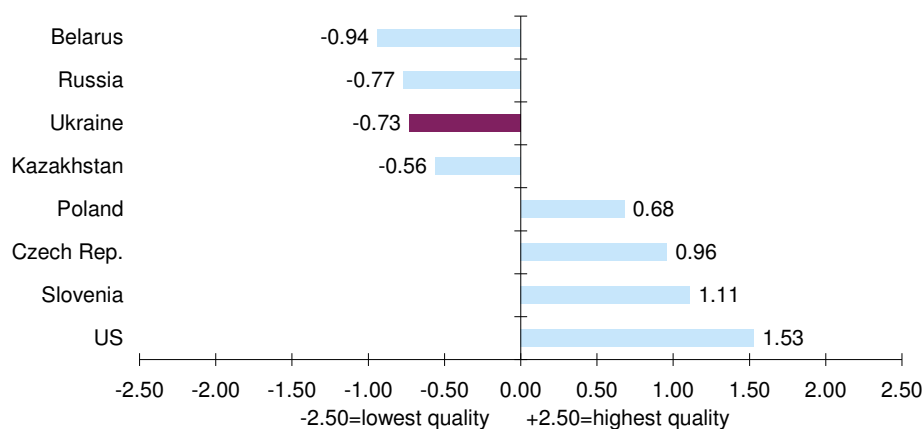
The legal and regulatory environment in Ukraine is problematic. In the World Bank's *Doing Business 2011* survey, Ukraine compares worst when it comes to paying taxes (rank 181), dealing with construction permits (179), registering property (164), and closing a business (150).

Judicial Environment

The judiciary is weak

The rule of law and protection of (intellectual) property rights are inadequate in Ukraine. The country's 'rule of law' score in the World Bank's 2009 *Worldwide Governance Indicators*, for example, is far worse than those of neighbouring Hungary, Poland and Slovakia (though better than Russia's). Out of the 213 countries included in the survey, Ukraine ranked 157. Ukraine compares relatively well (43 out of 183 countries) in the *Doing Business 2011* report in the ease of enforcing contracts. However, given the weakness of the rule of law, the value of this assessment is questionable.

Rule of Law, 2009



Note: The World Bank's *Worldwide Governance Indicators* are derived from annual surveys of businesses, citizens and experts in nearly 200 countries on six governance indicators: voice and accountability; political stability; government effectiveness; regulatory quality; rule of law; and control of corruption.

Source: World Bank, *Worldwide Governance Indicators*

Protection of intellectual property rights is insufficient

Ukraine remained on the ‘watch list’ for insufficient intellectual property rights (IPR) protection in the US Trade Representative’s 2010 *Special 301 Report*. The report acknowledged some continued progress on the issue (Ukraine was removed from the ‘priority watch list’ and placed on the ‘watch list’ in 2008) but pointed out that enforcement remained weak overall, and piracy levels were still high. It also highlighted Ukraine’s role in the trans-shipment of pirated and counterfeit goods. Among positive developments noted by the report was the updating of IPR laws and increased enforcement. Ukraine is a member of the World Intellectual Property Organisation (WIPO), a signatory to numerous conventions on IPR protection (including TRIPS), and has several bilateral agreements that cover the issue (including one with the EU).

Corporate Governance

According to the *Doing Business 2011* report, it takes 10 procedures and 27 days to start a business, compared with an OECD average of 5.6 procedures and 13.8 days. Relative to the country’s income level, the paid-in minimum capital needed to start a business is low (2.2% of income per capita, compared to 15.3% in OECD countries). The World Economic Forum’s *Global Competitiveness Report 2010/11* ranks Ukraine a dismal 138 out of 139 countries in the protection of minority shareholders’ interests, and a poor 128 in the strength of auditing and reporting standards. The following four are the major types of companies in Ukrainian law: joint stock company, limited liability company, full partnership (all partners hold joint liability for the business commitments) and limited partnership (the liability of one or more participants is limited, while at least one partner holds unlimited liability).

Employment Law

Enforcement of labour regulations is weak

The minimum working age is 16 (15 in some cases), the standard working week 40 hours. The minimum annual holiday entitlement of full-time employees is 24 days, plus public holidays. There is a legal minimum wage, although one that is barely above subsistence level; it currently stands at UAH922 (approximately USD115); the wage is raised every three months. Enforcement of labour regulations is often weak and informal employment frequent (see **Industrial Relations and the Labour Market**, p30).

Bankruptcy Procedures

Bankruptcy procedures are inadequate

As in many other former communist countries of Central and Eastern Europe, bankruptcy procedures are weak. According to the *Doing Business 2011* report, it typically takes 2.9 years to resolve a bankruptcy, with a recovery rate of just 7.9 cents on the US dollar. The recovery rate is far below the OECD average (69.1 cents per dollar), the average for Central and Eastern Europe and Central Asia (32.6 cents per dollar) and indeed is among the lowest in the world. In the OECD, it also takes less time to resolve a bankruptcy (1.7 years on average) but it is the very low recovery rate and the average cost of bankruptcy proceedings (42% of an estate’s value compared to 9.1% in the OECD) that places Ukraine on rank 150 out of 183 countries in the *Doing Business 2011* evaluation of insolvency procedures.

Financial Sector Supervision

Prudential regulation and supervision of the financial sector is split among three separate bodies: the National Bank of Ukraine (NBU; the central bank), supervises commercial banks (which dominate the financial sector); the State Commission for Regulation of Financial Services Markets supervises insurance companies, pension funds and other non-bank financial companies; and the State Commission for Securities and the Stock Market supervises the participants of capital markets.

Financial sector supervision is insufficient

Under pressure from the IMF, progress has been made in terms of private bank recapitalisation and strengthening the supervisory framework. However, financial sector supervision suffers from a number of major weaknesses, with the supervisory bodies inadequately staffed, funded and equipped, and lacking political support. One simple indicator of weak supervision is the high number of banks that operate in Ukraine: as of January 2010, there were 197, up steadily in recent years and a high number given the

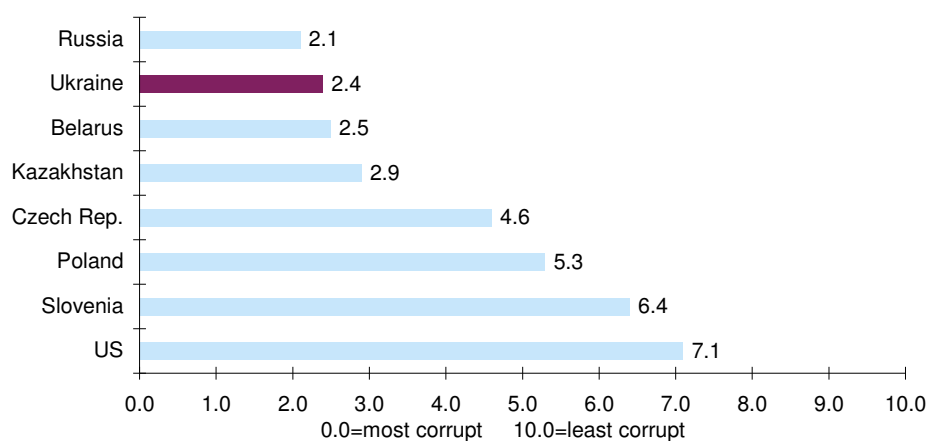
economy's size and state of development. Many banks offer only a very limited range of services, with some serving as 'house banks' for a single company only (creating problems of concentrated and connected lending). Also, both in its capacity as financial sector supervisor and in its monetary policy, the NBU failed to react adequately to alarming imbalances within the banking sector in the run-up to the financial crisis, most notably excessive credit growth.

Corruption

The level of corruption is perceived to be the same as in Zimbabwe

Corruption is endemic in Ukraine. In Transparency International's 2010 *Corruption Perceptions Index*, Ukraine ranked a poor 134 out of 178 countries, with a score of 2.4 (where 0.0 marks the highest level of perceived corruption and 10.0 the lowest). This puts Ukraine on a par with, among others, Azerbaijan and Zimbabwe, and far behind Estonia, whose score of 6.5 makes it the best-performing of the former communist countries of Central and Eastern Europe. While Ukraine's poor rating alone is cause for concern, it is made worse by there being no discernible improvement: in fact, Ukraine's 2010 rating was down from a high of 2.8 in 2006.

Corruption Perceptions, 2010



Source: Transparency International, *Corruption Perceptions Index*

Corrupt behaviour is present at every level of government. A group of wealthy individuals has strong influence on the political process, while polls regularly reveal that bribery of medical workers, teachers and professors, and traffic police are commonplace forms of petty corruption. Among the factors entrenching high levels of corruption are officials' low wages, unclear laws and light penalties for corrupt behaviour, which means that it is often easier to protect one's rights by paying a bribe.

Taxation

Corporation tax is set to fall to 16% by 2014...

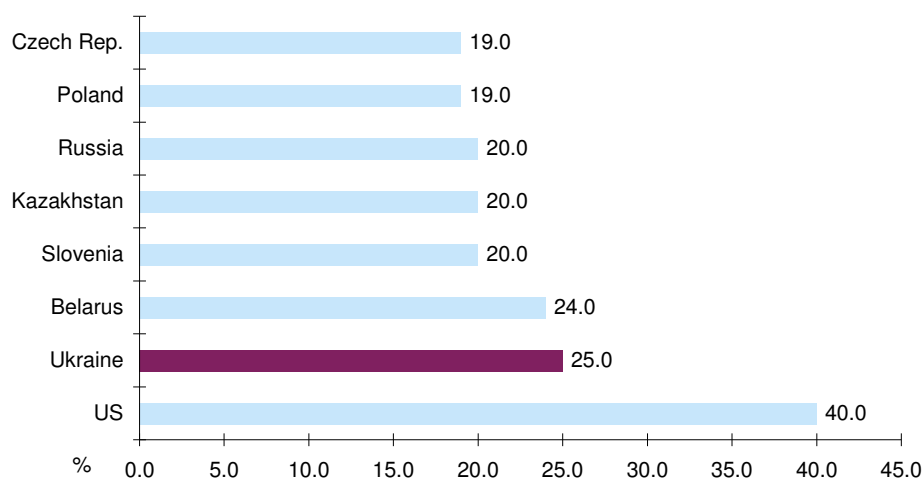
The headline corporate tax rate is 25%. However, under a new Tax Code approved by parliament in December 2010, corporation tax will be cut to 23% from 1 April 2011. Further phased reductions will see it decline to 16% by 2014; additionally, some sectors (namely light industry, the aviation industry and hotel services) will be exempt from corporate taxes for ten years. While these rates are below those of mature market economies such as Germany (29%), the US (40%) and Japan (41%), some caveats apply, notably the effective total tax rate on companies' profits (according to the World Bank's *Doing Business 2011* survey) is 55.2%, compared to an Eastern Europe and Central Asia average of 41.2%, and an OECD average of 43.0%.

...but tax system administration remains onerous

However, the headline tax rate conceals the fact that taxation is one of the major weaknesses of Ukraine's investment environment. According to the *Doing Business* indicators, Ukraine is the third-worst among the 183 countries included in the survey when it comes to paying taxes: for a medium-sized company, it takes no fewer than 135 payments to settle the annual tax bill, and preparing, filing and paying taxes takes no

less than 657 hours. This compares poorly with 41.7 payments and 313.9 hours for Eastern Europe and Central Asia as a whole and 14.2 payments and 199.3 hours for OECD countries.

Headline Corporate Tax Rates, 2010-11



Sources: KPMG, *Corporate and Indirect Tax Rate Survey*; D&B

VAT will be reduced to 17% by 2014

Personal income is taxed at a standard rate of 15%. Under the new Tax Code, personal income tax is charged at 15% for those with incomes less than ten times the minimum wage; those with higher incomes will be taxed at 17%. The standard VAT rate is 20%; this will be reduced to 17% by 2014. Goods and services exempt from VAT include domestic periodicals and books, medicines and other goods for medical purposes, special purpose goods for disabled persons, land plots, and domestically-produced infant nutrition (under certain conditions). Since the list of exemptions changes frequently, businesses are advised to contact a local tax expert for the most up-to-date list. An automatic VAT refund system has been introduced, which will increase the liquidity of Ukrainian firms and thereby reduce payment and credit risks. Government will now have to reimburse paid VAT within 23 days; currently the delays are significantly longer and more than UAH2.5bn (equivalent to USD300m) of VAT refunds to Ukrainian companies are overdue. At the same time, companies' ability to sue for monies owed (should the government fail to refund VAT) is questionable given the weak rule of law, notably the tendency for government to interfere in the workings of the judiciary.

Trade Environment

Current Account Exchange Regulations

There are a number of exchange controls

Ukraine has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the IMF Articles of Agreement. IMF members accepting these obligations agree to refrain from imposing restrictions on the making of payments and transfers for current international transactions and from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval. Restrictions are maintained on payments and on the provision of financial services to a number of countries in accordance with UN sanctions. At the same time, there are a number of exchange controls and registration requirements that are administered by: the National Bank of Ukraine, the central bank; authorised banks and other financial institutions; the State Tax Administration; the State Customs Committee; the Ministry of Communications; the Ukrpochta National Postal Communications Operator; and the Economy Ministry. Among other things, there are controls on the export and import of banknotes; importers must receive goods or services no later than 180 days from the date advance payment is made or a draft is provided (a licence is required if payment takes place more than 180 days in advance); there are documentation requirements for the release of foreign currency for payment of imports; and export proceeds must be repatriated through domestic commercial banks

within 180 days of the shipment of goods or rendering of services (a licence is required to extend the repatriation period beyond 180 days).

Trade Regulations

Ukraine joined the WTO in May 2008

Trade regulations in Ukraine are decidedly more cumbersome than in the OECD. Tariff barriers are generally low but importing into and exporting out of Ukraine takes substantially longer than in the EU and US, despite the country's WTO accession in 2008. Weak harvests have also repeatedly resulted in the imposition of limits on grain exports in recent years, with a ban in place until March 2011; further bans are possible in the future. In addition, the poor quality of the overall business environment is a concern to anyone conducting business in Ukraine. In the World Bank's *Doing Business 2011* report, Ukraine ranks a poor 139 out of 183 countries surveyed in the ease of trading across borders. The World Economic Forum's *Global Enabling Trade Report 2010* ranks Ukraine 81 out of 125 countries with a score of 3.84 (where 7.0 denotes a country with the strongest policies and factors for enabling trade, and 1.0 a country with the weakest policies and factors).

Tariffs

Tariffs are generally low

The simple mean import tariff for all products is around 4.3%, according to the World Bank's *World Trade Indicators*. This is much lower than in neighbouring Russia (11.1%) and also compares favourably with a number of other major emerging markets. For agricultural goods, the simple mean tariff is 9.8%. According to the WTO, more than 50% of non-agricultural imports, and somewhat more than 20% of agricultural imports, enter Ukraine duty free (compared with about 55% and 40%, respectively, in the US).

The import tariff system has three tiers. Preferred duty rates apply to imports from countries with which Ukraine has free-trade agreements, developing countries, and countries that have a preferential agreement with Ukraine. Concessional duty rates apply to countries that have most-favoured nation (MFN) agreements with Ukraine, which includes all WTO members (and, as such, the US and all EU member states). The general tariff rates apply to goods imported from other countries. Tariff regulations are most restrictive for agricultural goods and clothing. The average MFN applied duty is around 70% for beverages and tobacco and around 40% for animal products and sugar and confectionary. Very few dairy products, beverages and tobacco products, sugar and confectionary products, and clothing products enter Ukraine free of duty. By contrast, tariffs on raw materials and machinery are typically low.

Customs duties will be reduced under the auspices of the WTO

As part of its WTO accession Ukraine has committed to having its customs duties capped at rates between 0% and 50% (bound rates). Some of the reductions are being phased in by 2013. The highest allowed tariffs will continue to be applied to items such as sugar (50%) and sunflower seed oil (30%). Tariffs on certain product categories (e.g. pharmaceuticals, civil aircraft, chemicals, distilled spirits, petroleum oils, construction and medical equipment, steel, IT products, furniture, toys, wood, pulp, paper, yarn and fabric) have been, or will eventually be, eliminated. Imported goods are generally subject to VAT, which is levied at a standard rate of 20% (reducing to 17% by 2014). Excise tax is levied on goods including alcohol, tobacco, oil products, automobiles and jewellery, sometimes at high rates (often depending on whether the imported good is produced in Ukraine). Most imports are also subject to a stamp tax, and a licence fee of 0.1% of the total amount is levied on imports.

Ukraine has trade agreements with the US, EU and a number of other countries.

Trade Agreements with the US: A 1992 US-Ukraine trade accord provided reciprocal MFN status. In 2005, the US withdrew trade sanctions imposed on Ukraine in 2002 for a lack of intellectual property rights protection. In 2006, the US reinstated benefits under the Generalised System of Preferences and announced that it now considered Ukraine a market-based economy (which means that the standard, more lenient, market-economy methodology is now used for calculating anti-dumping duties in relation to

Ukraine). The two countries also signed a bilateral market access agreement in support of Ukraine's WTO accession, which has created new market access opportunities for US businesses.

Other Trade Agreements: Ukraine has signed free-trade agreements with each of the former Soviet republics, except Tajikistan (i.e. Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Russia, Turkmenistan, and Uzbekistan). Ukraine is negotiating a new partnership deal and a free-trade agreement with the EU, and is in talks on free-trade agreements with Canada. It has also signed a trilateral trade co-operation memorandum with Iran and Turkmenistan.

Black Sea Economic Co-operation (BSEC): The BSEC group was set up in 1992 and today consists of Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Serbia, Turkey and Ukraine. It has developed multilateral co-operation schemes in fields such as banking, energy, transport, telecommunications and trade, but efforts to remove barriers to trade among the member countries have been lacklustre at best.

Quotas and Licences

Import licences are required for some goods, including: pesticides, pharmaceutical products, alcohol products, optical media production inputs, some industrial chemical products and equipment containing them, sporting weapons and self-defence articles as well as some goods that contain sensitive encryption technologies. Imports of used cars that are five or more years old are banned. The import and sale of leaded gasoline is also banned. The Economy Ministry issues most import licences, although other ministries are responsible for the issuance of some of the licences.

Anti-dumping and Countervailing Duties

Ukrainian law provides for the protection of domestic producers from unfair foreign competition. Producers who believe that foreign competitors are dumping goods (i.e. selling them at below-cost price) on the Ukrainian market, or receive subsidies from their governments, can file for relief with the authorities. Given the strong influence of vested interests on government policy, there is ample room for anti-dumping and countervailing duties to be misused. Unsurprisingly, anti-dumping investigations against imports from competing low-cost producing emerging markets (in particular China) are relatively frequent.

Non-Tariff Barriers

Non-tariff barriers remain higher than in the OECD

Non-tariff barriers to cross-border trade remain higher than in OECD countries, despite Ukraine's accession to the WTO in 2008. According to the World Bank's *2011 Doing Business* survey, it takes eight documents and 36 days to import (and six documents and 31 days to export) a standardised shipment of goods. This is both considerably more than in OECD countries, while the cost of importing and exporting such a container is also higher in Ukraine than in the OECD.

Non-Tariff Trade Barriers, 2011

	<i>Ukraine</i>	<i>Region Average</i>	<i>OECD Average</i>
Documents required for export (number)	6	6.4	4.4
Time required for export (days)	31	26.7	10.9
Cost to export (USD per container)	1,560	1,652	1,059
Documents required for import (number)	8	7.6	4.9
Time required for import (days)	36	28.1	11.4
Cost to import (USD per container)	1,580	1,845	1,106

Note: The 'Region Average' is made up of non-tariff barrier data from the following countries: Albania, Armenia, Azerbaijan, Belarus, Bosnia & Herzegovina, Bulgaria, Croatia, Cyprus, Estonia, Georgia, Kazakhstan, Kosovo, the Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Romania, Russia, Serbia, Tajikistan, Ukraine and Uzbekistan.

Source: World Bank, *Doing Business*

Positively, after acceding to the WTO, Ukraine has to comply with the Technical Barriers to Trade agreement and give priority to international standards over regional and national ones. By the end of 2011, Ukraine's technical regulations will have to be based on the relevant international standards. The WTO Custom Valuation and Rules of Origin Agreements were fully implemented on accession.

Trade Documentation

The World Bank's *Doing Business* survey lists the following ten documents as required for imports into Ukraine: bill of lading; certificate of origin; commercial invoice; customs import declaration; customs transit document; equipment interchange receipt; packing list; and technical standard/health certificate. It lists the following six documents as required for exports: bill of lading; certificate of origin; commercial invoice; packing list; pre-shipment inspection clean report of findings; and technical standard/health certificate.

Investment Environment**Foreign Direct Investment**

There are few restrictions on foreign ownership

Generally speaking, foreign investors in Ukraine face the same difficulties as their domestic counterparts. The authorities have regularly declared that attracting FDI is one of their priorities; accordingly, there are few restrictions on foreign ownership (with the major exceptions concerning the media and the production of weaponry) and foreign investors generally receive the same treatment as domestic investors. The law on foreign investment includes ten-year protection against future legislative changes that affect foreign investors and protection from expropriation. Legislation also gives foreign investors national rights in the privatisation process. While there is no general requirement for investment permits, registration of foreign investments with the authorities is generally recommended. Although (on paper) foreign investors are well protected, the weak legal and regulatory environment means that the enforcement of claims may be somewhat protracted with no guarantee of success (see **Legal and Regulatory Environment**, p37).

Portfolio Investment

Securities markets remain under-developed

There are two main stock exchanges: the First Securities Trading System (PFTS), which was established in 1996, went electronic in 2005 and through which almost all trading takes place; and the Ukrainian Stock Exchange (USE), founded in 1992 by the government and ten commercial banks. While the range and volume of securities traded expanded extremely rapidly up to 2008, Ukraine's securities market is still at a very early stage of development. Moreover, the experience of even the most advanced former communist countries of Central and Eastern Europe suggests that it will take a long time for capital markets to assume a greater role in the economy. FDI and bank lending are by far the preferred sources of finance in the region.

Capital Account Exchange Regulations

There are various restrictions and controls on capital account transactions. These apply to capital and money market instruments, derivatives, credit operations, direct investments, real estate transactions and personal capital transactions. However, these stipulations are in line with those found in other emerging markets, and there has been a trend towards an easing of exchange regulations. The transfer of proceeds from the liquidation of direct investments, after payment of taxes due, is unrestricted. When the international financial turmoil began to significantly affect Ukraine in late 2008, the authorities imposed additional exchange controls to stem capital outflows. With an element of confidence restored, some controls on capital outflows were removed in April 2010, notably a ban on the early repayment of foreign borrowing.

Investment Incentives and Bilateral Investment Treaties

During her first stint as prime minister in 2005, Yulia Tymoshenko abolished all investment incentives. Despite a number of proposals, no new incentives have been introduced since. The US-Ukraine bilateral investment treaty, which took effect in 1996, provides protection for US investors. A bilateral tax agreement between the US and Ukraine, a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, came into effect in 2000. Other countries that have signed bilateral investment agreements with Ukraine include: Austria, Belgium, Bulgaria, Canada, Chile, the Czech Republic, Denmark, Egypt, France, Germany, Hungary, the Netherlands, Portugal, the Russian Federation, Spain, Switzerland and the UK.