



COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

**TO REFER THE DISPUTE REGARDING THE LAW OF UKRAINE ON THE
STIMULATION OF AUTOMOBILE PRODUCTION AND RELATED
REGULATIONS REGARDING THE SECOND HAND CAR MARKET TO
CO-OPERATION COUNCIL**

**TO DETERMINE THE POSITION TO BE ADOPTED BY THE COMMUNITY
IN THE CO-OPERATION COUNCIL TO SETTLE THE DISPUTE**

(presented by the Commission)

Explanatory memorandum

1. The Ukrainian government adopted, in September 1997, a set of laws granting fiscal privileges to enterprises which are committed to make a foreign investment of at least USD 150m and increase local content in accordance with a plan approved by the Ukrainian Government. These fiscal privileges apply de facto to one foreign company currently investing in the automobile sector in Ukraine.

These very substantial advantages include exemptions from all import duties on inputs used by the enterprise, exemptions from all VAT on inputs as well as car sales on the Ukrainian market, from land tax, from state innovation fund tax, as well as reducing the profit tax base for the company. This compounds with another special law writing off debt of the joint stock company AvtoZAZ, including various fiscal debts and officially guaranteed credits :

- the Law 'on the stimulation of automobile production in Ukraine' (n. 535/97-VR), adopted by the Ukrainian Parliament on 19 September 1997, in force since 23 October 1997.
- the Law on "the writing off of debt of the open joint stock company avtoZAZ" (n. 482/97 VR) of 18 July 1998,
- the law "on excise duty rates and import duty for certain vehicles and tyres for them" (n. 217/96 VR of May 96),

In addition, Ukraine has enacted a ban on the import of second hand cars more than 5 years old and imposed a USD 5,000 minimum customs value for all used cars. These additional measures lead to a practical halt of second hand car imports to Ukraine :

- the Resolutions of the Cabinet of Ministers "on changes and additions to certain resolutions of the Cabinet of Ministers of Ukraine" regarding the import of second hand car in Ukraine (146/98 of February 1998).

2. The European Commission has identified in the above-mentioned Ukrainian laws or provisions relating to the automobile sector in Ukraine a number of violations of the Partnership and Co-operation Agreement and/or elements incompatible with WTO rules. In particular these laws are contrary to art 10-MFN clause, 15-non discrimination and 49-state aids of the PCA, as well as to articles I and III of the GATT. The regulations regarding the second hand car markets are contrary to art 14 of the PCA.

These violations of Partnership and Co-operation Agreement and international rules are set out in detail below with a summary of the main provisions and their relation to above mentioned international rules :

Law 'on the stimulation of automobile production in Ukraine' (n. 535/97-VR)

<p><u>Duties on imported inputs (Art. 2.1)</u></p> <p>No import duties are levied on the importation of materials and parts for use by the enterprise to build cars. The list of approximately 250 products is defined, and the duty-free volumes will be determined by the Ukrainian Government.</p> <p>Car parts include car kits which consist of the body of the car with <i>not more than two</i> of the following assembled to it : engine, front suspension, rear suspension, fuel tank, ignition system, transmission system, exhaust system.</p>	<p>Violates Art. 10 PCA and Art. I GATT on MFN treatment for import duties on a <i>de facto</i> basis (de iure no advantages are granted to a specific country of origin).</p> <p>The classification of complete cars, presented unassembled, as car parts is not in accordance with the rules of the World Customs Organisation for the interpretation of the nomenclature. General Rule 2(a) of the Harmonised System stipulates that an article presented unassembled is to be classified under the Heading covering the finished product. The same rule applies to incomplete products having the essential character of the finished product. Consequently, a car body, completely equipped, presented with assembled parts such as the engine, the suspension or the transmission system, can be regarded as having the essential character of a car, and can be classified as such by virtue of General Rule 2(a).</p>
<p><u>VAT on imported inputs (Art. 2.3)</u></p> <p>No VAT is levied on the importation of materials and parts for use by the enterprise to build cars (same as for import duties). Like products of EU origin, including used cars, are taxed at 20% VAT</p>	<p><u>PCA</u></p> <p>Violates Art. 15.1 PCA providing national treatment for internal taxation, including VAT.</p> <p><u>Accession to WTO</u></p> <p>Violates Art. III GATT (national treatment for internal taxation, including VAT).</p>
<p><u>VAT on sale (Art. 2.3)</u></p> <p>Zero VAT is due on the sale of automobiles produced by the enterprise. This privilege is subject to the additional condition that the local content plan foresees to reach 70% local content by the end of a ten-year period. Like products of EU origin, including used cars, are taxed at 20% VAT.</p>	<p><u>PCA</u></p> <p>Violates Art. 15.1 PCA providing national treatment for internal taxation, including VAT.</p> <p><u>Accession to WTO</u></p> <p>Violates Art. III GATT (national treatment for internal taxation, including VAT).</p>
<p><u>Land tax (Art. 2.2)</u></p> <p>No land tax is due for a territory of x ha, with x being the amount of investment divided by USD 400,000. For an investment of USD 150m, this corresponds to 375 ha. The annual land tax is currently 9.05% of the value of the land.</p>	<p><u>PCA</u></p> <p>These privileges constitute subsidies. Violate art 49 of PCA, setting out that "Ukraine must "refrain from granting state aids which distort or threaten to distort competition insofar as they affect trade between the Community and Ukraine". In line with art.92 EC Treaty, the privileges are state aids as they benefit one particular enterprise and consist in benefits granted and revenue foregone by the state.</p> <p><u>WTO</u></p>

	These privileges constitute subsidies in the sense of art. 1.1 a) (1) ii of SCM. Since they are contingent upon local content, they are prohibited by art. 3.1 b) SCM.
<u>Profit tax (Art. 2.4)</u> The tax base is reduced with reinvestments and repayments on investment credits.	idem
<u>State Innovation Fund tax (Art. 3)</u> No State Innovation Fund tax is due. The tax rate is presently 0.3% of turnover (not profit).	idem
<u>The privileges are contingent upon the use of domestic over imported parts and components in accordance with a plan approved by the Ukrainian Government (Art. 1)</u>	<u>PCA</u> Violates Art. 15.2 PCA providing national treatment in respect of all laws affecting the internal use of imported products. The local content rule favours the use of domestic parts and components over imported ones. <u>WTO</u> Furthermore they constitute investment measures prohibited by Art.2 of the Agreement on TRIMs.

The Law 'on excise duty rates and import duty for certain vehicles and tyres for them' of 24 May 1996 (no. 217/96-VR) provides a further tax privilege for domestic car producers.

<u>Excise duty on passenger cars</u> Domestically produced cars are exempted from excise duty until 2007 on condition that at least 1,000 units are produced. The Daewoo/AvtoZAZ venture will benefit from this exemption. Excise duty rates on cars range from ECU 0.2 to ECU 1 per 1 cm ³ cylinder capacity.	Violates Art. 15 PCA and Art. III GATT which foresee national treatment for internal taxation, including excise duties.
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Resolutions of the Cabinet of Ministers "on changes and additions to certain resolutions of the Cabinet of Ministers of Ukraine" regarding the import of second hand car in Ukraine (146/98 of February 1998).

<u>Import prohibition on cars older than 5 years</u>	<u>PCA</u> Such prohibition corresponds to a zero quantitative restriction and violates art 14 of the PCA <u>WTO accession</u> Violates art.XI on quantitative restrictions
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<u>Minimum customs value of 5000 \$ on cars less than 5 years old</u>	<u>PCA</u> Violates art 16 of the PCA which contains a direct reference to art VII.2.a of GATT
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	<p><u>WTO accession</u></p> <p>Violates art VII.2.a of GATT on customs valuation.</p>
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3. The European Commission estimates the prejudice to EU producers on the new car market in Ukraine to more than 30% of the value (around 25% in tax exemptions and another 7% in subsidies, namely foregone state revenue).

4. The Commission's position :

- The Commission considers that such measures aimed at driving competition out of the Ukrainian market, are not only contrary to agreements signed by Ukraine and the policy of Ukraine to join WTO, but also run contrary to the general objective of Community assistance to Ukraine of supporting the integration of this country into the world economic order. Moreover, this policy sends a very negative message to other potential foreign investors and accounts for the low level of foreign investment recorded so far in Ukraine.

- The Commission considers that this matter needs to be pursued principally for the following reasons :

- **Attention needs to be drawn to Ukraine's commitments under the Partnership and Co-operation Agreement.** Ukraine takes insufficient notice of its international obligations, leading to a number of violations of the PCA.
- **This policy of discrimination tends to become normal practice :** three additional letters were sent by the Commission to the Ukrainian authorities during the Summer of 1998, regarding new issues of discrimination infringing PCA rules. The Ukrainian Government has stated that it intends to apply this policy with other ailing industrial enterprises (namely for shipyards). The Commission fully supports much-needed measures to attract foreign direct investment into Ukraine, but it is important at this stage to ensure that Ukraine understands the balance between perceived short-term gains and the longer-term benefits from its orderly integration in the world economy through the WTO and in full respect of bilateral agreements. The Commission will remain ready to assist Ukraine to find alternative ways of attracting foreign direct investment, in full respect of international rules and obligations.
- **Accession to the WTO will be very difficult** unless the violations of WTO rules under this Law are removed. In particular, the internal taxation privileges and probably also the import duty privileges will need to be extended unconditionally to all like products from all WTO member countries.
- **Action is needed to eliminate the harm which the law will cause to the exports of EC-manufactured cars** to the emerging Ukrainian market of 51 million people.

The Commission has presented its concerns relating to WTO and Partnership and Co-operation Agreement rules with, and offered to assist Ukraine to adapt its industrial policy to international rules :

- Official démarches were directed in Kiev towards the Government and Parliament in July 1997, and an aide-memoir was handed over.
- The issue was raised repeatedly in bilateral contacts in the WTO context.
- A letter from the Commission was sent to Deputy Prime Minister S. Tihipko and Minister for Foreign Economic Relations and Trade S. Osyka on 31 July 1997
- The issue was raised at the EU-Ukraine Summit meeting of 5 September 1997.
- A verbal note was transmitted to Ukraine on 21 October 1997.

Consultations were held in accordance with Art. 97 of the Partnership and Co-operation Agreement in March and May 1998 without result. Therefore the dispute should be referred to the Co-operation Council in accordance with Art. 96 of the PCA and as agreed at the 9 June 1998 meeting of the Co-operation Council.

The draft position to be adopted by the Community in the Co-operation Council to settle the dispute sets out the measures Ukraine should take so as to put its legislation in conformity with commitments agreed in the Partnership and Co-operation Agreement, and with WTO rules in the framework of Ukraine's accession procedure to the WTO : i.e. remove VAT, excise and customs duties discrimination, remove the local content clause, remove the ban on second hand cars older than 5 years, as well as minimum customs value on second hand cars, repeal discriminations in land tax, profit tax, state innovation fund payment.

The Council is therefore requested to :

- adopt the proposed decision to refer the dispute regarding the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market to the Co-operation Council and to determine the position to be adopted by the Community in the Co-operation Council to settle the dispute
- sign the draft letter in annex I to the President of the Co-operation Council, referring the dispute to the Co-operation Council.

PROPOSAL FOR A COUNCIL DECISION

to refer the dispute regarding the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market to the Co-operation Council

to determine the position to be adopted by the Community in the Co-operation Council to settle the dispute

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty, and in particular article 113 in conjunction with article 228, paragraph 2 first sentence and paragraph 3, first sentence thereof,

Having regard to the Council and Commission Decision of 26 January 1998 on the conclusion of the Partnership and Co-operation Agreement between the European Communities and their Member states and Ukraine (OJ L 49 of 19.2.1998), and in particular article 2.1 thereof,

Having regard to the Commission's proposal,

Whereas article 96 of the Partnership and Co-operation Agreement provides for the settlement of disputes,

Whereas the following laws of Ukraine violate the Partnership and Co-operation Agreement and consultations under article 97 of the PCA remained unsuccessful, for which reason it is now appropriate to refer the dispute to the Co-operation Council :

- the Law "on the stimulation of automobile production in Ukraine" (n. 535/97-VR), adopted by the Ukrainian Parliament on 19 September 1997, in force since 23 October 1997.
- the Law on "the writing off of debt of the open joint stock company avtoZAZ" (n. 482/97 VR) of 18 July 1998,
- the law "on excise duty rates and import duty for certain vehicles and tyres for them" (n. 217/96 VR of May 96),
- the Resolutions of the Cabinet of Ministers "on changes and additions to certain resolutions of the Cabinet of Ministers of Ukraine" regarding the import of second hand car in Ukraine (146/98 of February 1998).

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall refer the dispute on the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market to the Co-operation Council, by means of the letter attached in annex I, co-signed by the Commission and the Council and addressed to the President of the Co-operation Council.
2. The position to be adopted by the Community as regards this dispute shall be in accordance with the draft recommendation attached in annex II, to be proposed to the Co-operation Council for its adoption with a view to settle the dispute.

Done at Brussels,

ANNEX I

Draft letter from the Community to the President of the Co-operation Council with Ukraine

Mr. President,

The 9 June 1998 meeting of the Co-operation Council between the EU and Ukraine was informed of the situation that ensued from the law of Ukraine of October 1997 "on the stimulation of automobile production in Ukraine" (no. 535/97-VR) and the regulations regarding the second hand car market in Ukraine (resolution 146/98 of the Cabinet of Ministers of February 1998), as well as related legislation (law 482/97 VR of July 1997, law 217/96 VR of May 96), providing a set of discriminatory advantages to one company.

The Commission emphasised that this law is contrary to the PCA (art 10-MFN clause, 15-non discrimination and 49-state aids), as well as to articles I and III of the GATT. The regulations regarding the second hand car markets are contrary to art 14 of the PCA.

Formal consultations (under article 97 of the PCA) requested by the Commission as early as July 1997 took place in March and May 1998.

It was agreed at the 9 June 1998 meeting of the Co-operation Council that the Community would refer the dispute to the Co-operation Council under article 96 paragraph 1 of the PCA, in case consultations should remain without results within a period of two months as from the meeting of the Co-operation Council.

No compromise acceptable to the Community and its Member states was agreed with the Ukrainian authorities.

Therefore in agreement with the above mentioned decision, I have the honour to refer this dispute to the Co-operation Council. I enclose a draft recommendation which the Co-operation Council could adopt pursuant to article 96 paragraph 2 of the PCA so as to settle the dispute.

I would be grateful if you could transmit this letter as well as the annexed recommendation to members of the Co-operation Council as foreseen under article 6 of the Rules of Procedure.

For the Council of the EU

For the Commission

ANNEX II

Draft recommendation by the Co-operation Council regarding the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market in Ukraine

THE CO-OPERATION COUNCIL,

Having regard to the Partnership and Co-operation Agreement between the European Communities and their Member states and Ukraine, signed in Luxembourg on 14 June 1994 and in particular to art.96 thereof,

Having taken due account of the consultations undertaken by the parties under article 97 of the PCA,

Whereas the commitments provided for in the Partnership and Co-operation Agreement between the European Communities and their Member states and Ukraine, in particular under articles 10, 14, 15.1, 15.2, 16, 49 appear incompatible with some elements of the current laws regarding the automobile sector in Ukraine, in particular as regards the following points :

- i) local content requirement,
- ii) discriminatory exemption of indirect taxes,
- iii) discriminatory duty free imports of car components,
- iv) import prohibition on cars older than 5 years and minimum customs value on second hand car imports.

RECOMMENDS THAT :

1. Ukraine should undertake to adapt the current legislation according to the above mentioned elements, namely :

- the Law 'on the stimulation of automobile production in Ukraine' (n. 535/97-VR), adopted by the Ukrainian Parliament on 19 September 1997, in force since 23 October 1997 should be amended so that :

- (i) article 1 should define clear limits for semi knocked down kit imports,
- (ii) the provisions of art. 2.1 and 2.3 regarding the local content requirement should be removed,
- (iii) the provisions of art.2.1 regarding exemption from import duties should be amended, so that import duties are levied on a non-discriminatory basis,

(iv) The provision of art. 2.2 regarding exemption of land tax should be amended, so that land tax is levied on a non-discriminatory basis

(v) the provisions of art 2.3 providing zero VAT rate for import of materials and parts and sales of new cars should be amended so that VAT is levied on a non-discriminatory basis,

(vi) the provisions of art 2.4 providing a reduction of the tax base regarding the corporate profit tax should be amended so that the corporate profit tax is levied on a non-discriminatory basis,

(vii) the provisions of art 3 providing exemption from payments to the State innovation fund should be amended so that payment is non-discriminatory,

- the law "on excise duty rates and import duty for certain vehicles and tyres for them" (n. 217/96 VR of May 96), should be amended so that excise duties should be levied on a non-discriminatory basis.

- the Resolutions of the Cabinet of Ministers "on changes and additions to certain resolutions of the Cabinet of Ministers of Ukraine" regarding the import of second hand car in Ukraine (146/98 of February 1998) should be repealed.

- the Law on "the writing off of debt of the open joint stock company avtoZAZ" (n. 482/97 VR) of 18 July 1998, should be amended so that direct forgiveness of debts is not contingent upon local content.

2. Ukraine should undertake to consider alternative solutions such as the provision on a non-discriminatory basis of subsidies compatible with the PCA and the WTO agreement on subsidies and countervailing measures. (The elimination of discriminatory tax and tariff treatment would provide substantial additional resources to the Ukrainian budget, allowing for the provision of subsidies.)

3. Ukraine will report to the next meeting of the Co-operation Council on the steps it has taken to implement this recommendation.

Done at Brussels,

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