UKRAINE

TRADE SUMMARY

The U.S. goods trade deficit with Ukraine was $883 million in 2006, an increase of $318 million from $565 million in 2005. U.S. goods exports in 2006 were $756 million, up 41.9 percent from the previous year. Corresponding U.S. imports from Ukraine were $1.6 billion, up 49.3 percent. Ukraine is currently the 72nd largest export market for U.S. goods.

The stock of U.S. foreign direct investment (FDI) in Ukraine in 2005 was $356 million (latest data available), up from $256 million in 2004.

WTO Accession

Ukraine is in the process of negotiating terms of accession to the World Trade Organization (WTO). On March 6, 2006, the United States and Ukraine signed a WTO bilateral market access agreement. Later that month, the United States terminated the application of the Jackson-Vanik amendment to the Trade Act of 1974 to Ukraine, providing Ukraine permanent normal trade relations (PNTR) status. The Ukrainian government has completed its bilateral market access negotiations with most other interested WTO Members, and is now focused on completing its implementation of WTO provisions and resolving remaining outstanding issues involving WTO rules. Ukraine must also complete negotiations on the levels of funding for certain programs supporting its agriculture sector. Ukraine made significant progress during 2006 in passing legislation needed for compliance with WTO requirements, enacting some 20 WTO-related laws in the fall of 2006 and adding to its steady progress in this area in the previous two years. Members of Ukraine's WTO accession Working Party, including the United States, are planning onward steps in the multilateral Working Party process for Ukraine's WTO accession.

IMPORT POLICIES

Ukraine continues to maintain fees and licensing requirements on certain imports. Ukraine imposes several duties and taxes on imported goods: customs/import tariffs, value-added-tax (VAT) and excise duties. Additionally, imports into Ukraine are subject to customs processing fees, a unified fee on vehicles crossing Ukraine's borders and port fees.

Customs/Import Tariffs

Ukraine's tariff schedule provides for two rates of import duty: full rates and Most Favored Nation (MFN) rates. The full rate of import duty can be from two to ten times higher than the MFN rate; it is applied to goods from 81 countries. Imports from the United States are subject to the MFN rate. Upon accession, Ukraine would apply the MFN rate to all goods originating from WTO Members, in accordance with Article I of the GATT 1994.

Import duties are calculated in accordance with the law "On the Customs Tariff of Ukraine" introduced in 2001, although their levels currently undergo frequent changes as a result of Ukraine's ongoing negotiations on WTO accession. The current customs tariff schedule comprises approximately 11,000 tariff lines. Most customs tariffs are levied at *ad valorem* rates, but 1,655 tariff line items (about 15 percent) are subject to specific and combined rates of duty. These specific and combined rates apply to approximately one-third of tariff-lines for agricultural goods, primarily those that are produced in

Ukraine. These protected goods include grains, poultry products, sugar, and vegetables such as carrots and potatoes. In 2005, the Ukrainian Parliament, the Rada, passed amendments to the Customs Code of Ukraine, which decreased tariff rates in an effort to meet WTO accession requirements. The average applied tariff rate for all goods is now 6.5 percent. For agricultural goods, the average applied rate is 13.8 percent (down from 19.7 percent) and for industrial goods the average applied rate is 4.4 percent (down from 8.3 percent). Import tariffs were particularly high with respect to petroleum products; they were reduced, however, to zero during a summer 2005 shortage of gasoline and diesel fuel and have not increased again despite a number of proposals in the Rada.

High import tariffs on goods such as poultry act as a barrier to U.S. exports. As a result of the March 2006 WTO bilateral market access agreement with the United States, tariffs on poultry and many other goods will be reduced significantly when Ukraine joins the WTO.

In terms of customs-related issues affecting trade, imports of U.S. salmon roe (red caviar HS Code 0303 or 0305) were delayed when, early in 2005, the Ukrainian State Customs Service reclassified the products as fish roe substitute (HS Code 1604), which would require payment of a higher customs tariff. The State Customs Service requires court decisions to clear the products under the correct category, causing delays and leading to diminished U.S. exports of this highly perishable product.

Excise Duties

Ukraine applies excise duties to a limited set of goods imported into Ukraine, such as alcoholic beverages, non-filter cigarettes, motor vehicles and petroleum products. Most of the excise duties that established lower rates for domestically-produced goods than for imported goods were eliminated in 2005, but discriminatory excise duties still hinder U.S. exports of wine and grape spirits and automobiles to Ukraine. The excise duty rate on imported wine and grape spirits is 12 and 13 times higher, respectively, than on domestically-produced products, and is likely to remain at that level until Ukraine accedes to the WTO and excise rates on imported and domestic goods are unified. VAT and excise tax exemptions for locally-produced vehicles were eliminated on March 29, 2005. Excise taxes on automobiles remain high, ranging from 0.2 euros/cc for automobiles with smaller engines to 3 euros/cc for those with larger engines. Since the excise tax rate is based on the cubic capacity of the engine, it is biased against automobiles with larger engines. The import tariff on fully assembled automobiles was raised from 15 percent to 25 percent during 2005 to compensate local producers for the loss of VAT and excise privileges. This increase has negatively impacted importers of fully assembled automobiles, who are also disadvantaged since the tariff on semi-knocked down vehicles is lower.

Import Licenses

Import licenses are required for some goods, including pesticides, alcohol products, optical media production inputs, some industrial chemical products and equipment containing them, official foreign postage stamps, excise marks, officially stamped/headed paper, checks and securities, some goods that contain sensitive encryption technologies, and ozone-depleting substances. An importer is required to receive prior approval from the relevant administrative agency before receiving the necessary import license from the Ministry of Economy. Pursuant to the March 2006 U.S. bilateral market access agreement, Ukraine will not impose import licenses on imports of mass-market, commercially-traded goods containing encryption that are covered by the Information Technology Agreement. Additionally, in 2006, the Rada added fresh, chilled, or frozen beef and pork and related live animals to the list of goods subject to a form of automatic import licensing, where the requirement for prior approval from an administrative agency is waived. Poultry imports are already subject to such licensing.

For some goods, product certification is a prerequisite for an import license. Importers can certify the compliance of a foreign facility to Ukraine's technical regulations applied to imports. The U.S. distilled spirits industry reports that this option usually involves a burdensome visit and costly inspection by Ukrainian government officials. If approved, the supplier receives a certificate of conformity valid for two to three years, which avoids the burden of certification of each shipment, subjecting goods to mandatory laboratory tests upon arrival in Ukraine.

STANDARDS, TESTING, LABELING AND CERTIFICATION

For a number of years, U.S. investors regarded Ukraine's product certification system as a significant obstacle to trade and investment. U.S. businesses have complained that standards and certification requirements adversely affect their consumer goods exports. In January 2006, however, Ukraine's Parliament passed two new laws aimed at bringing Ukrainian practices in this area into line with the WTO Agreement on Technical Barriers to Trade. As of April 2006, more than 3,100 Ukrainian standards were harmonized with international standards, and approximately 8,000 remained to be harmonized.

Standardization and Certification

Mandatory certification is required in Ukraine for many products. The State Committee for Technical Regulation and Consumer Policy (DerzhSpozhyvStandard) is the standardization and certification body in Ukraine. DerzhSpozhyvStandard has a network of 115 accredited product certifying bodies including 53 accredited certifying bodies for quality management systems, as well as about 780 testing laboratories throughout Ukraine. Appropriate resources, such as modern analytical equipment and reactants, are not available in most laboratories. DerzhSpozhynStandard's system includes 27 territorial departments for consumer protection and 28 state centers for standardization, systematizing weights and measures, and certification. Depending on the type of product, testing and applicable certification scheme, the certification process can take from three days to one month.

Numerous certification bodies in Ukraine effectively operate as independent, often monopolistic, entities on a profit-making basis, returning just 20 percent of their fees to the state. Consequently, certification agencies do much of their regulatory work with little or no coordination with other Ukrainian bodies performing similar tests. Many products require multiple certificates from different agencies, with local, regional and municipal authorities often requesting additional documentation beyond that required by central bodies. According to industry sources, access to the Ukrainian market is impeded by numerous burdensome certification and licensing procedures for equipment. These issues are being addressed during Ukraine's WTO accession negotiations, and in recent years, Ukraine has reduced the number of products subject to mandatory certification. When Ukraine completes its implementation of the WTO Agreement on Technical Barriers to Trade when it accedes to the WTO, it will be obliged to apply such mandatory requirements only in conformity with WTO provisions on technical regulations (i.e., only in defense of human, animal and plant health and safety), and only based on sound science.

Sanitary and Phytosanitary (SPS) Measures

Ukraine has, in the past, applied a range of SPS measures that restrict imports of a number of U.S. agricultural products, among them, pork, beef and poultry. Ukraine's certification and approval process is lengthy, duplicative and expensive. In 2005, amendments to several laws, including the law "On Veterinary Medicine," and law "Quality and Safety of Food Products and Food Raw Materials," were made to bring Ukrainian legislation into compliance with requirements of the WTO Agreement on the Application of Sanitary and Phytosanitary Measures. Further, legislation to bring Ukrainian law into compliance with international norms regarding veterinary medicine, standards, conformity assessment procedures and other sanitary and phytosanitary measures remain at various stages of drafting and consideration by Ukraine's Parliament. The following issues are subjects of discussion between the United States and Ukraine as part of Ukraine's accession to the WTO:

Beef, Beef Products and Pork: The March 2006 WTO bilateral market access agreement with the United States addresses the terms of U.S. exports of beef, beef products and pork to Ukraine. The two sides signed detailed veterinary certificates related to such goods. As agreed, Ukraine will allow the entry of certified U.S. beef and pork that meets veterinary certificate requirements. The United States is currently monitoring whether trade will be allowed to clear customs, as this is required for Ukraine to adhere to the bilateral commitments mentioned above.

In the past, Ukraine blocked the importation of beef and beef products due to concerns over the use of growth promoting hormones as well as bovine spongiform encephalopathy (BSE). The United States is working with Ukraine to ensure that any measures undertaken by Ukraine are consistent with World Organization for Animal Health (OIE) guidelines. Ukraine's Law of Veterinary Medicine is expected to address this issue.

U.S pork exports to Ukraine have been hampered by regulations concerning trichinae. The United States is working with Ukraine so that it takes the necessary steps to align Ukrainian standards for trichinae with international norms.

Biotechnology: Ukraine's biotechnology approval process has been inoperative for some time. This has resulted in unpredictable sales conditions for corn products, soybeans and meal. The United States is working with Ukraine to establish procedures regarding biotechnology that are based on modern, science-based risk assessment principles and guidelines, including those of the WTO SPS and Technical Barriers to Trade (TBT) Agreements, the Codex Alimentarius, and the International Plant Protection Convention (IPPC).

Fish Shelflife: As part of the bilateral WTO market access agreement with the United States, the Ukrainian government agreed in March 2006 to approve changes to Ukraine's technical regulation on shelflife for fish such as salmon, sardines and roe to bring it into conformity with the CODEX Alimentarius guidelines on the labeling of prepackaged food products and to repeal the previous technical regulation. The government of Ukraine agreed to accept use-by/sell-by dates that are determined solely by the manufacturer.

GOVERNMENT PROCUREMENT

Ukraine is not currently a signatory to the WTO Agreement on Government Procurement (GPA) but will negotiate for membership after it joins the WTO. Ukraine's total government procurement stood at $4.1 billion in 2005 and $3.1 billion for the first half of 2006. Foreign companies generally win only a tiny fraction of the total tenders (0.01 percent during the first half of 2006).

In March 2006, Ukraine promulgated amendments to the law "On Procurement of Goods, Works and Services Using State Funds" of February 22, 2000. The amendments transferred the authority to coordinate government procurement from the Ministry of Economy to the Antimonopoly Committee of Ukraine. The amendments also distributed the authority to oversee government procurement among a range of the governmental agencies, including the Antimonopoly Committee, the Accounting Chamber of

Ukraine, and the Tender Chamber of Ukraine. The amendments have been criticized for creating an overlap in authority of various regulatory agencies and decreasing the transparency of the system.

The 2006 amendments also granted the Tender Chamber of Ukraine, a non-governmental organization (NGO), exclusive authority to consider claims of tender participants and issue conclusions. At the same time, this association of public organizations is granted administrative powers characteristic of a state administration agency. The amendments also introduce burdensome and lengthy procurement procedures, and require all tender proposals to be secured by collateral, which limits the number of tender participants and increases the cost of participation.

All government procurement of goods and services valued at more than 2,000 euros and works valued at more than 100,000 euros must be procured through competitive tenders. Open international tenders must be used when procurement is financed by any entity outside of Ukraine. The Tender Chamber of Ukraine publishes information on government procurement in the "State Procurement Bulletin."

Among the problems faced by foreign firms, particularly in smaller procurements, are: (1) the lack of public notice of tender rules and requirements; (2) covert preferences in tender awards; (3) subjecting awards to conditions that were not part of the original tender requirements; and (4) the lack of effective grievance and dispute resolution mechanisms. Although the law prohibits discrimination based on national affiliation, U.S. pharmaceutical companies cite instances where local firms have won government tenders even where the U.S. firms provided the most competitive offer. The law favors local tender participants for purchases of goods not exceeding 200,000 euros, of services not exceeding 300,000 euros, and of works not exceeding 4 million euros. The preference is applied as long as the price differential does not exceed 10 percent. When Ukraine negotiates for membership in WTO Agreement on Government Procurement, many of these issues can be addressed.

EXPORT BARRIERS

Exports for some categories of products are subject to registration by the Ministry of Economy. Products that must be registered prior to export from Ukraine include: precious metals and stones, rolled metal products exported to the United States, textile products exported to the United States, scrap metal, printer's ink and paper with watermarks. The government has eliminated most export duties, with the prominent exceptions of natural gas, livestock, raw hides, some oil seeds and scrap metal.

Export Restrictions on Grains

Ukraine is the sixth-largest wheat exporter in the world. The United States remains very concerned about the export quotas and licenses that Ukraine imposed on food and feed grain exports beginning at the end of September, 2006. To date, Ukraine has not adequately justified the measures taken, i.e., it has not made the case that it faces a "critical shortage," as required under the General Agreement on Tariffs and Trade of 1994. Several studies point to the contrary. The World Bank's November 2006 report titled "The Quotas on Grain Exports in Ukraine: ineffective, inefficient, and non-transparent" states that the introduction of the quota was not justified, as domestic grain supply was amply adequate to cover all domestic needs. Data from the Food and Agriculture Organization of the United Nations and industry confirm this finding. Further questions are raised by the scope of the measures: the quotas and licenses are being applied to corn and barley, which are not being used for the production of bread in Ukraine, and to corn, barley and wheat used as feedstock.

Meanwhile, the small volumes of licenses that have been issued by the Ukrainian government in late December fall very short of historical trade, especially for wheat. The mismanagement of the issuance of licenses has compounded the problem, leaving a large volume of grain in storage in Ukraine's ports, where in some cases it is deteriorating past the point where it can be used for human consumption, or even animal feedstock.

It is estimated that the costs to grain traders of demurrage and losses from rotting or otherwise compromised grain that has not been able to leave Ukraine's ports will exceed $200 million. The Ukrainian economy is sustaining some of these losses, including lost export opportunities. Ukraine's reputation as a reliable grain exporter, a country that upholds contracts and a good place to invest, is tarnished by these measures. Further, the measures have begun to have a negative impact on Ukraine's farmers themselves, as they have difficulty financing, planning and selling their current and future products.

Live cattle, sheep, hides, and skins

Export duties have been in place on live cattle, sheep, hides and skins since 1996. For live calves the duty is 75 percent of the customs value (but no less than 1500 euros/ton of live weight); for live cows it is 55 percent (but no less than 540 euros/ton of live weight); and for live sheep it is 50 percent (but no less than 390 euros/ton of live weight). For raw hides of cattle the duty is 30 percent (but no less than 400 euros/ton of live weight); for sheep hides it is 30 percent (but no less than 1 euro/hide); and for pigskins the duty is 27 percent (but no less than 170 euros/ton of live weight). The Ukrainian government has committed to lowering these export duties gradually upon WTO accession.

Scrap Metal

Since January 2003, Ukraine has imposed an export duty of 30 euros/metric ton on ferrous steel scrap and has had, in effect, a ban on exports of non-ferrous metals. The ferrous scrap export duty contributed to a decline in scrap exports from Ukraine, when global demand and prices for steel scrap were rising. Ukrainian metallurgical producers benefited from scrap inputs at prices lower than world levels. As part of its March 2006 bilateral WTO market access agreement with the United States, Ukraine agreed to significantly lower these export duties. Laws passed in the fall of 2006 provide for staged duty reductions to 10 euros/metric ton over a period for six years for ferrous metals and reductions to 15 percent *ad valorem* over a period of five years for non-ferrous metals.

Sunflower Seeds

Sunflower seeds have been subject to an export duty since June 2001, to the benefit of local sunflower oil producers. In July 2005, the export duty on sunflower seeds was lowered to 16 percent of its customs value with further 1 percent annual reductions, to start in 2007, reaching a final duty of 10 percent six years after WTO accession.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

The United States withdrew Ukraine's benefits under the Generalized System of Preferences (GSP) program in 2001 and imposed trade sanctions and elevated Ukraine to the Special 301 Priority Watch List in 2002 as a result of Ukraine's record of not protecting intellectual property, such as widespread piracy of copyrighted goods such as compact discs (CDs) and digital video discs (DVDs). The United States lifted sanctions on August 30, 2005, after the Ukrainian government made significant improvements to IPR protection over a number of years, culminating in the passing of amendments to the "Laser-Readable Disk Law" in July 2005. In recognition of Ukraine's efforts to improve the enforcement and protection of intellectual property rights, on January 23, 2006, the United States also reinstated GSP benefits for

Ukraine and lowered Ukraine's designation under Special 301 from Priority Foreign Country to Priority Watch List.

Optical Media

The establishment of a regulatory regime for the production, distribution and export/import of optical media several years ago was a major advance. Many of the deficiencies in Ukraine's early laws, which failed to stem the commercial-scale pirate production of CDs, CD-ROMs and DVDs, were addressed by the amendments to the "Laser-Readable Disk Law," which was enacted in July 2005. These new amendments, drafted in close consultation with U.S. industry and the U.S. Government, enhanced law enforcement's role and lowered the threshold for imposing penalties and sanctions. These amendments related to issues such as: (1) establishing a system for monitoring raw materials (optical grade polycarbonate) for optical media production; (2) creating a clear obligation to engrave all manufacturing equipment and molds with SID Codes; (3) expanding non-compliance penalties to include plant closures and deterrent criminal penalties; and (4) stronger enforcement authority to seize infringing machinery and products. Industry recently has identified a problem area with optical disk regulation: alleged counterfeiting of the holograms that legitimate producers are to use, the sale of such holograms on the black market in Ukraine, and their application to pirated CDs and DVDs to circumvent enforcement efforts. The United States has encouraged Ukraine to continue to conduct surprise inspections of optical disc manufacturing facilities, to aggressively prosecute any offenders and shut down pirating plants, and to continue its enforcement efforts at the retail level.

In the first eight months of 2006, the State Department for Intellectual Property (SDIP), the agency responsible for the formulation and implementation of Ukraine's intellectual property laws, and the Ministry of Interior conducted 544 inspections of plants and retail establishments resulting in 101 criminal cases and the seizure of 231,000 units of pirated products valued at more than $1.28 million. All of these numbers exceed the totals for 2005. Furthermore, the Ministry of Internal Affairs, Ministry of Culture, the General Prosecutors' office and the State Security, Tax and Customs Administration have developed a joint program to coordinate their enforcement efforts. In September 2006, Ukraine was notified that it would receive $150,000 in U.S. Government funding to continue efforts to improve prosecution of optical media piracy cases through a grant administered by U.S. Embassy Kyiv, the Ukrainian Ministry of Internal Affairs and SDIP.

Despite the reduction, or near elimination, of illegal production of optical discs, retail sale of copyrighted goods in large markets – especially the notorious Petrivka market – continues to be rampant. Counterfeit hologram stickers complicate enforcement efforts at the retail effort; industry generally regards the hologram sticker system as flawed if not broken. The transit of pirated goods also remains a large problem.

Internet Piracy

In January 2006, the government of Ukraine agreed to work with the U.S. Government and with the U.S. copyright industry to monitor the progress of future enforcement efforts through the Enforcement Cooperation Group (ECG). This bilateral group conducted a successful dialogue in June 2006 that brought additional IPR concerns to Ukraine's attention, particularly the non-transparent operation of copyright royalty collecting societies in Ukraine. In these cases, collecting societies claim to represent performers and rights holders and try to legitimize websites that are allegedly selling pirated music and films. Meanwhile, certain collecting societies have no such arrangements with rights holders or do not remit royalties and fees to them. The United States looks forward to Ukraine amending its Law "On Copyright" to better address the role of collecting societies. The United States continues to monitor the spread of Internet piracy in Ukraine and to work with the Ukrainian government to ensure that its gains on IPR are not reversed. The two governments have agreed to begin joint monitoring of suspected pirate websites.

Business Software

In addition, industry is concerned with growing 'at-source' pre-loaded business software piracy. U.S. industry reports $290 million in losses in Ukraine in 2006 due to business software piracy, and singles out the Ukrainian government as a source of piracy. In June 2006, Microsoft canceled a software legalization agreement with the government of Ukraine due to lack of compliance.

Compliance with Trade-Related Aspects of Intellectual Property Rights (TRIPS)

Ukraine's efforts to accede to the WTO have required it to make some important revisions to its IPR laws. The Rada passed amendments to its Customs Code in November 2006 that provide customs officials the ability to use *ex officio* authority to seize suspected pirated or counterfeit goods. As a result of commitments agreed to as part of its March 2006 WTO bilateral market access agreement with the United States, Ukraine amended its Law "On Medicinal Drugs" to provide a five-year period for the protection of pharmaceutical test data that is submitted to government authorities to obtain marketing approval. This "data exclusivity" protection enters into force in February 2007. The Rada also passed an amendment to the Law "On Pesticides and Agrochemicals" that provides a ten-year period of protection for agricultural chemicals and an amendment to the Law "On Protection of Rights for Indications of Origin of Goods," which sought to improve Ukraine's geographical indications legislation. Further amendments to its legislation related to geographic indications are necessary to bring Ukraine's legislation into full compliance with TRIPS provisions.

Patent and Trademark

The government of Ukraine acknowledges that patent and trademark violations are a problem. Holders of patents or trademarks must often engage with the Ministry of Internal Affairs or the State Customs Service to obtain protection of their rights. Trademarked and copyrighted goods must be registered for a fee ($400 for the first good for the first year; $200 for every next new good; $100 for extension of the registration for the next year) in the Customs Authorities' rights holder database in order to be guaranteed protection. Industry has reported instances of production of counterfeit cigarettes within Ukraine as well as the growth in the amount of counterfeit pesticides and apparel.

The Ukrainian Ministry of Health does not routinely check the validity of patents when it permits pharmaceutical sales in Ukraine. In one case, the Ministry of Health allowed a European company to register the same drug for which a U.S. company held a valid patent. Legal experts and government officials have called for the formation of a special patent court in Ukraine to adjudicate patent cases, but no action has yet been taken to establish the court.

Judicial System

As a result of the low number of judges trained in IPR law and a lack of confidence in the Ukrainian judicial system, civil IPR lawsuits are almost non-existent. The Ukrainian government, however, has brought to court a number of criminal cases related to trademark and copyright violations and the retail sale of pirated goods. The Ministry of Internal Affairs reported that in the first eight months of 2006, 639 crimes in violation of intellectual property rights were detected; of those, 293 were brought to court, and 40 resulted in sentencing of some form, including fines or imprisonment.

SERVICES BARRIERS

Ukraine has few explicit restrictions on services, but they do exist in areas such as insurance, banking activities, auditing, legal services, television and radio broadcasting, and information agencies. As a result of the March 2006 bilateral WTO agreement with the United States, U.S. service providers will benefit from more open access in the areas of energy services, branching in banking and insurance, professional services, express delivery, and telecommunications, among others.

In 2005, the Ukrainian Parliament adopted legislation that will, within five years after WTO accession, permit foreign insurance companies to open branches in Ukraine. In the fall of 2006, it adopted amendments to the law on "Banks and Banking" that would permit foreign banks to open subsidiaries, and adopted a law "On Advocacy" that eliminates the nationality requirements for legal services.

Foreign professionals are permitted to work in Ukraine, but the lack of transparency and the multiplicity of licensing authorities hinder foreign access to the Ukrainian services market. A local content requirement exists for radio and television broadcasting, although it has not been stringently enforced in most cases. Additionally, in January 2006 Ukraine's Parliament adopted a new law on television and radio broadcasting that eliminated restrictions on the share of foreign capital in the charter funds of television and radio broadcasting companies.

U.S. industry identified efforts in Ukraine in 2006 to limit the ability of foreign credit and debit card service providers to provide their services to clients of national electronic payments systems. Ukraine has taken on services commitments in the context of WTO negotiations to maintain an open and competitive banking system, including credit and debit cards, with full market access to electronic payments services. At present, there are no formal restrictions. The United States continues to monitor Ukraine's compliance in this important area.

INVESTMENT BARRIERS

An underdeveloped banking system, poor communications networks, a difficult and frequently changing tax and regulatory climate, crime and corruption, and a weak legal system create obstacles to U.S. investment in Ukraine. The government is working to streamline regulations and eliminate duplicative and confusing laws regarding investment and business. In 2005, Ukraine created several agencies in order to attract investment to Ukraine, including the State Center for Foreign Investment Promotion within the Ministry of Economy, the State Agency for Investment and Innovation, and the State Agency for Investment and Innovation under the President.

The United States has a Bilateral Investment Treaty (BIT) with Ukraine, which took effect in 1996. The BIT guarantees U.S. investors the better of national and MFN treatment, the right to make financial transfers freely and without delay, international legal standards for expropriation and compensation, and access to international arbitration. Despite the BIT, there are a number of longstanding investment disputes faced by several U.S. companies. These disputes mainly date from the early 1990s and the initial opening of the Ukrainian economy to foreign investors. In most cases, however, there has been little progress toward resolution of these cases under subsequent Ukrainian governments.

Taxation

In 2003, Ukraine passed legislation on tax reform, establishing a flat tax on personal income of 13 percent, which will be raised to 15 percent as of January 1, 2007, in accordance with new legislation. In

2003, the Ukrainian government lowered the enterprise profit tax from 27 percent to 25 percent. Arrears in the payment of VAT refunds to exporters has also been a serious problem. Although some improvement in arrears was observed in late 2005 and early 2006, in August 2006, the government of Ukraine decreased the pace of VAT refunds, reimbursing only 76 percent of verified claims, down from 87 percent refunded in 2005. Currently, the process for obtaining a refund of VAT payments can take from 3 to 18 months for foreign companies. In March 2005, the government of Ukraine extended to foreign companies the right to use promissory notes for the payment of VAT on inputs to goods destined for export.

Employees currently pay 3.5 percent of their salaries to state social insurance funds and a 13 percent personal income tax. Additionally, employers pay 38 percent to various state social insurance funds, primarily for pensions. The 2007 draft budget lowers the pension fund tax on salaries by 0.5 percent, but increases payroll tax to the State Pension Fund by 1.4 percent. The 2007 draft budget is heavily criticized for its failure to address payroll deductions to social funds, which is the most burdensome tax. The high payroll taxes are the main reason why shadow wage payments remain common in Ukraine.

Special Economic Zones (SEZs)

Ukraine has in the past maintained two forms of special economic zone (SEZs): Free Economic Zones (FEZs) and Priority Development Territories (PDTs). In April 2005, Ukraine canceled all tax exemptions (i.e., from land tax, corporate income tax, import duty and VAT on imports) to investors in all SEZs to stop large-scale misuse of these zones for tax evasion and smuggling. While the step reduced corruption and expanded the tax base, the abrupt cancellation of privileges and lack of compensatory provisions caused substantial losses to some legitimate investors. Plans to renew tax privileges granted to businesses operating in some SEZs and a compensation mechanism for investors are under consideration by the Ukrainian government. The Ukrainian government also claims that the newly-constituted SEZs will operate in compliance with WTO provisions. On November 15, 2005, the Parliament adopted legislation to create technology parks, providing for some government financial support, targeted subsidies and tax privileges for a list of 16 technoparks based on existing scientific and research institutes.

Privatization

The State Property Fund oversees the privatization process in Ukraine. Privatization rules generally apply to both foreign and domestic investors, and, in theory, a relatively level playing field exists. In contrast to the privatization rush in 2004, few major, new privatizations were conducted in 2005 or 2006. As of October 2006, only 15 percent ($64 million) of this year’s target for privatization has been transferred to the budget. Following a difficult reversal of the non-transparent privatization of Ukraine's major steel plant Krivorizhstal, which was subsequently sold in a transparent, well-run tender to Mittal Steel in 2005, the Ukrainian government stated that it had no further plans to reverse previous privatizations.

Ukraine’s Parliament amended the Land Code of Ukraine in October 2006, extending a moratorium on the sale of farmland until January 1, 2008. This provision blocks private investors from purchasing some of the 33 million hectares of arable land in Ukraine and will likely constitute a serious obstacle to the development of the agricultural sector.

Corporate Hijacking

Currently, several companies in Ukraine are experiencing an escalation in corporate hijacking activity. These hijackers take advantage of deficient legislation, corrupt courts and a weak regulatory system to gain control of companies at the expense of rightful shareholders. This development harms investors, including U.S. companies and shareholders, and has damaged the image of Ukraine among foreign investors. The Ukrainian government has recognized the seriousness of this problem but has yet to effectively address it.

ELECTRONIC COMMERCE

Electronic commerce is underdeveloped in Ukraine, particularly in the areas outside of Kyiv, where active Internet users number only 7.5 percent of the total population. There is a higher level of usage in Kyiv, where 60 percent of city residents are reportedly active Internet users and where Internet commerce, while small in total volume, is experiencing strong annual growth. Many of the elements needed for thriving electronic commerce, such as high consumer demand for goods and services, capable software engineers to design websites and availability of credit cards are present in Ukraine. However, the low levels of usage, limited services by retailers and a general distrust among the population prevent electronic commerce from gaining popularity. The more than 100 Internet retailers that exist in Ukraine are almost entirely based in Kyiv. Most Ukrainian Internet retailer sites consist of price lists or advertising with an option to place an order that later could be delivered after a cash payment, card payment or bank transfer is received. In some instances, Internet shops accept online payments from clients of their partner banks only. The main products sold via the Internet are home appliances and electronics, especially mobile phones, while the main services include Internet banking and online bill payment for utilities.

In 2003, the Ukrainian parliament adopted three laws regulating the Internet and establishing a framework for the telecommunications market. The National Council on Communications is entrusted with monitoring the telecommunications market. The Internet in Ukraine remains mostly unregulated. In April 2005, the Ministry of Transport and Communication introduced a controversial regulation forcing registration of Internet websites in Ukraine. The law was cancelled in October 2005, however, after a public outcry labeled the measure a violation of freedom of speech and expression.

OTHER BARRIERS

Problematic Legal Framework

A sound legal system and properly running judiciary system are critical for sustainable economic growth, reducing the cost and risk of doing business, and attracting FDI. Unfortunately, the Commercial and Civil Codes, a foundation for the entire legal system in Ukraine, are full of discrepancies and conflicting provisions. Both codes became effective in January 2004, but their approaches to the regulation of business activities (i.e., issues related to regulation of bank accounts, securities, contracts, etc.) are contradictory. The Commercial Code has a number of provisions considered to be incompatible with market economics, and most experts believe it should be eliminated entirely.

Inspections

The frequency of inspections by regulatory agencies is one of the major hindrances to business development in Ukraine. The annual number of inspections conducted throughout the country exceeds 1.5 million. According to a recent study, 57 percent of the private businesses in Ukraine consider inspections to be unclear, complicated and non-transparent. Ukraine's system of inspections does not fulfill its main purpose of preventing legal abuses, but is primarily punitive in nature.