



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 26.07.1999
COM(1999)390 final

99/0171(ACC)

Proposal for a

COUNCIL DECISION

to pursue the dispute settlement procedure related to the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market with the appointment of a conciliator and proposals to the Co-operation Council for a third conciliator in accordance with Art. 96 par. 3 of the Partnership and Co-operation Agreement

to adopt the draft mandate for the conciliators with a view 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 5000 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 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 (referred to or incorporated in art. 10 and 15 of the PCA). The regulations regarding the second hand car markets are contrary to art 14 of the PCA. The law on the stimulation of automobile production in Ukraine, in addition to Art. I and III GATT, is also inconsistent with the WTO Agreement on Trade related investment measures (Trims), in particular as it corresponds to the measures described in point 1.(a) of the illustrative list annexed to the Trims Agreement and thereby prohibited;

The ban on second hand cars imports is also inconsistent with WTO rules, in particular Art. XI GATT (general elimination of quantitative restrictions);

The minimum customs value of USD 5000 for all used cars contravenes Art VII and the WTO Agreement on the implementation of Art. VII (Customs valuations agreement).

3. The dispute settlement procedure launched under art 96 of the Partnership and Co-operation Agreement was not deemed successful.

As formal consultations (under article 97 of the PCA) in March 1998, remained unsatisfactory the Community referred the dispute to the Co-operation Council on 23.12.98 under article 96 paragraph 1 of the PCA, as agreed at the Co-operation Council meeting of 9 June 1998, and submitted a draft recommendation to be adopted by the Co-operation Council pursuant to article 96 paragraph 2 of the PCA.

Ukraine's reply of 29 January, 1999 addressed some elements requested by the Commission during previous consultations, notably local content, VAT exemption on sales, and exemption from excise duties on sales. On these points Ukraine commits itself to amend the law before the end of 2000, so as to remove the local content clause and extend VAT exemption on sales, and exemption from excise duties on sales to all cars. In addition it was announced (in the Ukrainian paper of 20 April on market access issues in preparation of the Co-operation council), that "a draft was prepared with a view to removing the minimum customs value". **Other points are not addressed** namely: the exemption of import duties on imported inputs, VAT exemption on imported inputs, the ban on second hand car imports, as well as other tax exemptions (land tax exemption, profit tax exemption, State innovation fund tax exemption).

State of play regarding the main contentious issues :

- **local content, VAT exemption on sales** : Ukraine's commitment to amend the law in December 2000 is confirmed (during the 19 March consultations), though the EU request to do it at an earlier date was not taken into account (however this commitment will have to be implemented as soon as possible, so as not to stall Ukraine application to the WTO).

On the proposal of Ukraine to extend VAT exemption on sales to all cars, the Commission had emphasized that the implementation of a reasonable level of non-discriminatory VAT to imported and locally assembled vehicles would be more in line with international donors' requirements regarding the restructuring of Ukraine's tax system, while being consistent with the provisions of the PCA. Indeed the proposal to extend VAT exemption on sales to all cars may be at odds with the recommendations of the IMF and the Commission regarding the budget balance. Moreover it does not seem to be reflected in the government's draft tax code.

- **subsidies** : Ukraine argues that as the local content clause was removed (in fact it is currently still in existence and will hopefully be removed by December 2000, following the commitment of 1 February 1999), subsidies are no longer prohibited, that they are just actionable provided "adverse effects" can be observed. This is allegedly a "non-issue" as there is no car export to the EU. The Commission disagrees with this view, as actual prejudice is caused to EC car sales on the Ukrainian market, due to the discriminatory advantages, and this is indeed the main stake in this issue. This is why these subsidies are not compatible with art. 49 of the PCA.

- **MFN (customs duties exemption) on imported inputs/spare parts** : Ukraine argues that these advantages are not specific, as no country of origin is mentioned in particular and that the conclusions of the Indonesia panel of the GATT are not valid.

Ukraine's reply alleges that it allows "imports of spare parts from any country of origin to benefit from the import duty exemption". The Commission retains the view that there is a de-facto infringement of Art 1 of GATT 1994, as confirmed by the Panel on Indonesia which ruled that "tax and tariff benefits infringe art I.1 because they are not provided unconditionally to all like products". The law of Ukraine spells out that the exemption of import duties applies to the import of goods "that are used for the production...of the enterprise producing automobiles and their spare parts with an investment ...no less than 150 mio \$" (art 2.). This is in contradiction with the findings of the Indonesia panel mentioned above.

- **the ban on second hand car imports** : No progress was recorded on this issue. The proposal of Ukraine to set up a group of technical experts to consider the ecology and safety risks related to the import of car older than 5 years in Ukraine does not seem appropriate to the Commission, as this is not a technical issue regarding environment and safety but a measure of trade policy. Alleged environment and safety aspects are not decisive in this respect. Moreover this issue has been discussed at length during previous consultations. Therefore this proposal would merely delay progress towards a settlement.

- **Other tax exemptions** (land tax exemption, profit tax exemption, State innovation fund tax exemption) : are deemed legal by Ukraine under GATT/WTO rules. The Commission emphasizes that these privileges 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. 87 (ex-92) of the EC Treaty, the privileges are state aids as they benefit one particular enterprise and consist in benefits granted and revenue foregone by the state.

4. The Commission's position :

The last Ukrainian note verbale dated 24 April, 1999, following new consultations of 19 March 1999, does not bring any new element of substance that would be liable to foster the settlement of the dispute. It leaves several points unsolved such as the exemption of import duties on imported inputs, VAT exemption on imported inputs, the ban on second hand car imports, as well as other tax exemptions (land tax exemption, profit tax exemption, State innovation fund tax exemption). Moreover the last proposals of the Commission's services for compromise solutions were not taken into account.

It should be noted that no concrete action was so far undertaken by Ukraine to implement the EU recommendation of 8.12.98, all proposals are simply commitments to act by the year 2000.

5. In the absence of further progress the Commission proposes to pursue the dispute settlement procedure as announced at the Co-operation council of 26 April, including the nomination of an EC conciliator in accordance with Art. 96 par. 3 Partnership and Co-operation Agreement.

6. Therefore the Commission proposes a choice of three personalities of which one should be appointed as conciliator on behalf of the EC. The two others should be proposed by the EC to the Co-operation Council as potential third conciliator. The proposed conciliators are :

- Dr. M. Schuette, Cabinet Bruckhaus-Westrick-Heller-Löber (Brussels)
- Me. Jack Bussy, Cabinet BDLT (Paris)
- Me M. Merolla, Cabinet Bonelli-Erede-Pappalardo (Brussels)
- The Council is therefore requested :
 - to adopt the proposed decision to pursue the dispute settlement procedure regarding the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market as announced at the Co-operation council of 26 April, with the appointment of a conciliator in accordance with Art. 96 par. 3 of the Partnership and Co-operation Agreement,
 - to adopt the draft mandate for the conciliators with a view to settle the dispute,
 - to sign on behalf of the Community the draft letter in annex I to the President of the Co-operation Council, giving notification of the appointment of a conciliator for the EC side.

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to adopt the draft mandate for the conciliators with a view to settle the dispute

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty, and in particular article 133 paragraph 4 in conjunction with article 300 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,

- (1) Whereas article 96 of the Partnership and Co-operation Agreement provides for the settlement of disputes,
- (2) Whereas the following laws could also form the object of examination in the Working Party on the accession of Ukraine to the WTO, of which the European Communities are a Member, and whereas the two processes are totally different in nature, the possible solution of the dispute under article 96 of the Partnership and Co-operation Agreement, could not be considered as determining the Commission's position during these negotiations,
- (3) Whereas the following laws of Ukraine violate the Partnership and Co-operation Agreement :
 - 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).

- (4) Whereas consultations under article 97 of the PCA remained unsuccessful, for which reason it is now appropriate to pursue the dispute settlement procedure with the appointment of a conciliator

HAS ADOPTED THIS DECISION:

Single Article

1. In accordance with article 96 paragraph 3 of the Partnership and Co-operation Agreement, the Community shall pursue the dispute settlement procedure regarding the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market.

2. Therefore Mr..... is appointed as EC conciliator to contribute to the settlement of the dispute in the framework of the attached mandate. This appointment will be notified 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.

3. The Community shall propose in due course to the Co-operation Council the designation of Mr..... or Mr as third conciliators.

4. The mandate for the conciliators attached in annex II is hereby adopted. This appointment will be notified 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.

Done at Brussels,

For the Council
The President

ANNEX I

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

Mr. President,

On 23.12.98 the Community referred the dispute related to 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), to the Co-operation Council under article 96 paragraph 1 of the PCA, as agreed at the Co-operation Council meeting of 9 June 1998, and submitted a draft recommendation to be adopted by the Co-operation Council pursuant to article 96 paragraph 2 of the PCA.

The Community has repeatedly 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 (referred to or incorporated in art. 10 and 15 of the PCA). The regulations regarding the second hand car markets are contrary to art 14 of the PCA. The law on stimulation of automobile production in Ukraine, in addition to Art. I and III GATT, is also inconsistent with the WTO Agreement on Trade related investment measures (Trims), in particular as it corresponds to the measures described in point 1. (a) of the illustrative list annexed to the Trims Agreement and thereby prohibited. The ban on second hand car imports is also inconsistent with WTO rules, in particular Art. XI GATT (general elimination of quantitative restrictions). The minimum customs value of USD 5000 for all used cars contravenes Art VII and the WTO Agreement on the implementation of Art. VII (Customs valuations agreement).

Whereas Ukraine's reply of 29 January, 1999 addresses some elements requested by the Community during previous consultations, notably local content, VAT exemption on sales, and exemption from excise duties on sales, other points are not addressed namely : the exemption of import duties on imported inputs, VAT exemption on imported inputs, the ban on second hand car imports, as well as other tax exemptions (land tax exemption, profit tax exemption, State innovation fund tax exemption).

The Ukrainian note verbale of 24 April 1999 following new consultations of 19 March 1999, brings no new element of substance to the settlement of the dispute. Therefore, in the absence of further progress the Community decided to pursue the dispute settlement procedure (in accordance with Art. 96 of the PCA) as announced at the Co-operation council of 26 April, with the appointment of a conciliator in accordance with Art. 96 par. 3.

Therefore in agreement with the above mentioned decision, I have the honour to notify that the Community has appointed Mr..... as EC conciliator, to contribute to the settlement of the dispute. The EU expects Ukraine to appoint its conciliator within two months according to art 96 paragraph 3 of the Partnership and Co-operation Agreement.

I would be grateful if you could transmit this letter to members of the Co-operation Council as foreseen under article 6 of the Rules of Procedure with the annexed mandate for the conciliators and address to the Community an acknowledgement of receipt from the Ukrainian party.

For the Council of the EU

For the Commission

ANNEX II

Draft mandate for the conciliators regarding the dispute settlement procedure related to the law of Ukraine on the stimulation of automobile production and related regulations regarding the second hand car market in Ukraine

- **Objectives and tasks**

- 1. Provide the parties with an advisory opinion assessing the following legislation and its conformity with the rules of the PCA and WTO :**

- 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),

- ban on the import of second hand cars more than 5 years old and imposed USD 5000 minimum customs value for all used cars.

- 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).

Check in particular the conformity of these regulations in relation to :

- the PCA : art. 10-MFN clause, art 14, 15-non discrimination and 49-state aids,

- the GATT: articles I and III (referred to or incorporated in art. 10 and 15 of the PCA) articleVII paragraphs 1, 2, 3, 4a, 4b, 4d, 5 (referred to or incorporated in art. 16 of the PCA), article XI (general elimination of quantitative restrictions)

- the WTO : the Trims Agreement and the Agreement on the implementation of article VII of the GATT (customs valuation agreement).

- 2. Elaborate normative proposals on how to settle the current trade dispute between Ukraine and the EC.**

- 3. Contribute to the settlement of the dispute in co-operation with the two other conciliators**

- **The duration of this procedure should not exceed two months.**