The debate on elimination of free enterprise zones in Ukraine

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Introduction: There is a great deal of capital available to come to Ukraine, but there are too few viable projects from the point of view of investors. Ukraine has the human capital, consumer markets, location, natural resources and infrastructure to grow rapidly for a sustained period. Yet the administrative business environment, security of property rights, minority shareholder rights and ability to enforce contracts are lacking to the degree that Ukraine continues to forgo the lion's share of its opportunities for sustainable growth. Given the apparent incapacity to improve the business climate throughout the country, and a desire to develop especially depressed regions, starting in 1999 the authorities turned to the creation of free enterprise zones, where basic ingredients needed by investors were to be secured within pre-defined territories, and where special privileges were awarded. Among the motivations for these zones, it was thought that they would help to attract technology and foreign investment to Ukraine.

Zone Characteristics: Ukraine has a multitude of sector subsidies, free trade zones and priority development areas. The following industries are considered "priority" and have been receiving subsidies of different magnitude during the last five years: shipbuilding, coal mining, steel, motorcars, aircraft, space, chemicals, pharmaceutical, and construction.[2] In addition, there are eleven free economic zones in Ukraine today: Azov, Donetsk, Zakarpattya, Interport Kovel, Kurortopolis Truskavets, Mikolaiiv, Porto Franco Odessa, Port Crimea, Reni, Slavutich, and Yavoriv. There are also nine special priority areas granting privileges comparable to those of free economic zones. For purposes of brevity moving forward, all types of Ukraine's free or special zones in Ukraine will be referred to, simply as "zones".

The privileges are granted not to all activities in the zones but only to a list of investment projects specified by government resolutions. In order to qualify, a project should meet the following criteria:

- the project belongs to the list of priority types of economic activity;
- minimal investment is in an amount from US$0.2–3.0 million, depending on the type of the activity;
- the project is approved by the zone authorities; and
- there is a contract with relevant Central Government bodies.

Table 2.1 lists privileges that, prior to legal changes earlier this year, had been granted in each special economic zone. It illustrates well the *ad hoc* nature of special economic zone regulations. Each zone offers a unique set of privileges to investors. Not surprisingly, legal arrangements for zones and territories are extremely complicated. Besides a few umbrella laws

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[1] This note was drafted by Mark Davis, drawing directly from the Ukraine Trade Policy Study, WB, November 2004, available on the World Bank website: worldbank.org.ua. It also significantly benefits and draws directly from comments kindly provided by IMF operational staff.

[2] Some of these subsidies may be viewed by the WTO as export subsidies since they target all production, both for domestic sale and for exports.

on free economic zones, each zone has to be created according to a separate law passed by Parliament, in accordance with the Constitution of Ukraine.

Table 1: Main Privileges Granted to Investors in the Territory of Special (Free) Economic Zones, 2004

Zone	Special customs regime	Exemption from enterprise profit tax	Exemption from investment taxation	Exemption from payment of customs duties and VAT on imports	Exemption from mandatory sale of foreign currency earnings	Exemption from land tax	Exemption from duties to some other budgetary fund
Azov	Yes	20 percent rate	Yes	No	Yes	Zero rate during development	Yes
Donetsk	Yes	20 percent rate	Yes	No	Yes	Zero rate during development	Yes
Zakarpattia	Yes	20 percent rate	No	No	Yes	No	Yes
Yavoriv	No	Zero rate for 5 years; half of standard rate afterwards	No	For 5 years	No	Zero rate for 3 years; half of standard rate afterwards	Yes
Slavutich	No	Zero rate for 3 years; half of standard rate from year 4-6	Yes	For 5 years	Yes	Zero rate for 3 years; half of standard rate from year 4-6	Yes
Kurortopolis Truskavets	No	Zero rate for 3 years; half of standard rate from year 4-6	Yes	Yes	Yes	Zero rate during development; half of standard rate for another 10 years	No
Porto Franco Odessa	Yes	Zero rate for 3 years; half of standard rate from year 4-6	Yes	No	Yes	No	No
Reni	Yes	20 percent rate	Yes	No	Yes	No	Yes
Port Crimea	Yes	20 percent rate	Yes	No	Yes	Zero rate for 5 years	Yes
Interport Kovel	Yes	20 percent rate	No	No	Yes	Zero rate for 5 years	Yes
Mikolaiiv	Yes	Zero rate for 3 years; half of standard rate from year 4-6; free reinvestment from year 4-10	Yes	For 5 years	Yes	Zero rate for 5 years	No

Source: *Ministry of Economy and European Integration.*

Export Facilitation? The main goal of zone formation was regional development through establishing business-friendly enclaves. Export facilitation was to be of secondary importance. In fact, zones and territories export about one-third of their output, which constituted about four percent of total Ukraine exports in 2003. As seen from the table, some (but not all) zones enjoy

special customs regime (customs territory). In some zones, imports that are consumed in the free economic zones are exempt from import duties. Goods originating in the free economic zones, and shipped to the customs territory of Ukraine outside the zones, are exempt from customs duties. This creates serious cost advantages for producers in the zones as compared to those outside of zones. It thus both discourages investment outside of these zones, and creates potential rent-seeking opportunities for zone administrators. According to the Ministry of Economy, duty-free importation of raw materials is the main channel of tax subsidies, which contradicts the primary goal of such zones as a vehicle for facilitating technology and foreign investment. In 2004, the Ministry of Finance estimated that the "tax expenditures" represented by these tax privileges was about 350 million UAH, or only about 0.1 percent of GDP. But the revealed value of tax expenditures consumed by these zones would be much larger if shadow activity and/or intra-corporation transfer pricing could be calculated.

What about WTO and Ukraine's EU Aspirations? There are at least three controversial topics in WTO accession negotiations concerning free economic zones. One, import duties from some zones and priority development areas are not collected when goods made in free economic zones are sold outside of the zones, but inside the customs territory of Ukraine. This violates WTO rules. Two, preference to investment projects that promise to procure Ukrainian-made goods contradicts the WTO Agreement on Trade Related Investment Measures (TRIMS). Third, direct tax incentives can be interpreted as discriminatory direct tax measures for protection against imports, export assistance, domestic production, or to deter or attract foreign investment. For instance, a lower corporate income tax rate for export-oriented firms, is equivalent to levying a non-discriminatory corporate income tax rate, combined with the provision of an export subsidy.[3]

As regards the EU, The EC Treaty (Article 92(10)) requires that, "*any aide granted by a member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the comment market*."[4]

What can Ukraine learn from international experience? Overall international experience with free trade zones is mixed.[5] The cross country evidence on economic zones makes clear the following: (a) they are not a first-best solution – overall improvement of the investment climate is first best, (b) they are only one instrument among many for promoting export development and growth, and tend to have limited applicability and impact, (c) they work best when focused on export facilitation, (d) they work best in countries with developed infrastructure and financial markets where downward linkages can be developed to domestic economic activity, (e) they are distortionary trade instruments which introduce discretion into the policy environment, and as

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[3] See M. Daly, "The WTO and Direct Taxation", WTO, June 2005, Discussion Paper No. 9.

[4] While the Treaty does not define the concept of "aide", nor does it lists the types of measures which it prohibits, the Commission and the Court of Justice have mapped out the bounds of the concept. In particular, to be caught by Article 92(1), the measure must be selective. That is, it favors certain undertakings or the production of certain goods. Profit tax holidays for companies located in a free zone, for example, are clearly prohibited. A low-rate profit tax applying generally would not be prohibited. That said, the major exception to the general ban on state aid is aid to help regions suffering from serious problems of economic underdevelopment, and many member countries have taken limited advantage of this exception.

[5] See for instance, "A Review of the Role and Impact of Export Processing Zones" by Dorsati Madani, Policy Research Working Paper 2238, The World Bank, November 1999.

such they are vulnerable to abuse, and (f) once privileges are provided through them, the lobby builds to maintain and expand those privileges.

One special aspect of zones that is often overlooked is that they act as a safety valve for attracting investment when the overall business climate is poor, and as such they reduce pressure on the government to improve the business climate for all investors (domestic and foreign, large and small). Typically, the investment attracted through them is small as a share of GDP, and can draw attention away from improvement of the overall investment climate which would attract more significant levels of investment.

In cases where the decision has been taken to form zones, some advised characteristics are as follows:

- Tax incentives within the zone should be limited to relief of customs duties and indirect taxes (VAT and excises). Goods that enter the zone from the domestic economy should be treated as *exports* (from the domestic economy), and hence can be zero-rated for VAT and entitled to customs duty drawback when appropriate. Goods can be exported from the zone to other countries without tax consequences. When goods enter the domestic economy from the zone, they should be treated as *imports*, and be subject to the applicable customs duties, VAT and excises. As FEZs are treated as being extra-territorial, the perimeters should be secured and under effective customs control.
- Export processing zones may offer advantages over duty drawback or suspension mechanisms for exporters, including: (i) simplified administration; (ii) a small cash flow benefit, as duties are not paid when goods enter the zone only to be refunded later; (iii) more comprehensive relief, since the duty drawback and suspensions only cover duties paid or payable by the exporter, since it is not possible to trade the input through multiple domestic transactions; (iv) exemption from customs duty on equipment used in the zone; and (v) infrastructure provision.
- Provision of direct-tax incentives is very much a second-best option, and should be done in a manner that minimizes economic distortions and is in line with WTO agreements. To minimize distortions, direct tax incentives might be limited to those directly related to the amount of investment—for example, by including accelerated depreciation or tax credits as part of the standard tax code—and not take the form of tax holidays. Further, as mentioned above, any direct tax incentive might contravene WTO agreements, depending on its specific design and applicability. In general, it is preferable to have investment incentives explicitly included the law, and available to all enterprises in equal terms—including those outside the zones. They should not be granted discretionarily.

Do tax exemptions pay off? Surveys on private investment behavior[6] show that tax incentives are far from being the only—or even a critical—element determining a country's attractiveness for foreign direct investment. Market size and growth prospects, wage-adjusted labor productivity, availability of infrastructure, reasonable levels of taxation, stability of the overall tax regime, a simple and fair licensing system, a clear legal frameworks where contracts can be enforced, and the quality of bureaucracy, are all important elements in the investment decisions

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[6] Working Group of the Capital Markets Consultative Group, "Foreign Direct Investment in Emerging Market Countries," September 2003.

of foreign and domestic companies. The use of special tax incentives to overcome other deficiencies tends to be overly costly, both in terms of lost tax revenue, increased economic distortions, and its vulnerability to abuse and tax evasion. In particular:[7]

- *They are not a cost-effective way of promoting investment in new enterprises,* which typically are less profitable in early years; the principal beneficiaries are firms that are highly profitable at the outset and do not need incentives;
- *They are not an effective method for attracting foreign investment,* since they convey no ultimate tax benefit to enterprises with parents in countries offering a credit for taxes paid abroad;
- *The granting of tax incentives creates opportunities for corruption and rent-seeking activities.* For example, they provide strong incentives for tax avoidance, as taxed enterprises could enter economic relationships with exempt ones to shift their profits to the latter through transfer pricing. Further, the duration of income tax holidays, even if formally time-bound, is prone to abuse and extension by investors through creative re-designation of an existing investment;
- *The revenue costs to the budget are seldom transparent*, unless the enterprises enjoying tax holidays are still required to file proper tax returns (in which case, administrative activities must be devoted to activities that yield no revenue).

What is Ukraine doing about the zones? Ukraine's zones are not consistent with good practice, and there is little evidence that they have succeeded in generating additional economic activity in Ukraine. Rather, valuable government resources (e.g., through taxes foregone) and attention have been allocated to the zones, arguably at the expense of successfully implementing improvements in the investment climate throughout the territory of Ukraine.

In light of this evidence, and in the context of Ukraine's overall program of eliminating tax privileges, it has been clear that regulations governing these zones needed to be revamped. The Government recognized this when it introduced a moratorium on new zone creation. Under the Second Programmatic Adjustment Loan, supported by the World Bank, the government committed to bring its tax privileges down to a level consistent with best international practice. Significant progress has been achieved on that front, in part through action taken earlier this year to eliminate tax privileges in the zones. The IMF has repeatedly expressed its concern about the zones, has strongly supported the elimination of tax exemptions, and in its recent Article IV Board conclusions, urged to resist pressures to re-open the tax loopholes closed in the 2005 budget..

At the same time, across the board elimination of zone privileges potentially creates moral hazard issues. In true cases of foreign direct investment, where the conditions for the privileges were met by the investing firms, elimination of the privileges in effect breaks a contract between the State of Ukraine, and the investor. This may require some form of compensation. But at the same time, some extraordinary privileges have been granted for up to 60 years; these were not realistic even at the time the contracts were signed. In addition, recently, Ukraine has implemented partial tax reform, including a significant reduction in corporate income taxes.

[7] See also "Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries" by H. Zee, J. Stotsky and E. Ley, World Development, Vol 30, No. 9, 2002.

This was likely unexpected by most participants in the zones. Ukraine's improved macroeconomic track record and perceived reductions in political risk (e.g., bond spreads have come down significantly) are also overall benefits to foreign investors already in Ukraine.

The new administration took action through the 2005 Budget and supporting legislation by eliminate all of the privileges of all of the free trade and priority development zones. While over the years there has been considerable public discussion on this issue, the steps taken in 2005 were surprising and were done without consultation of privilege holders.[8] Also, while the privileges were eliminated, investment and other commitments of enterprises that started business in the zones through these special programs have been retained.

What should the Government do now? At present, the issue continues to require careful management. The following steps are recommended:

1. Uphold the Verkhovna Rada's decision to eliminate the special privileges of enterprises in the zones. In return, compliment this by eliminating all special commitments of firms within the zones. Accompany this by a statement of the government's intensions to honor reasonable commitments through an objective and credible process to determine whether compensation is due to investors. And if so, use this process to determine the amount and method of payment, with recourse to acceptable arbitration arrangements where necessary..

2. Focus more attention on improving the investment climate throughout Ukraine's entire economy.

3. Eliminate VAT refund arrears, and complete Ukraine's tax reform as soon as possible.

4. Eliminate all differential treatment between foreign and domestic companies.

5. With support of the IFI's, hold consultations with the EU, WTO and especially with the embassies based in Kyiv about the reform nature of Ukraine's decision to eliminate the zones, and Ukraine's intentions to improve the investment climate for all investors.

[8] It should be admitted that had there been consultation, the path to eliminating the privileges would likely have been more difficult.