

# **Business Environment Study**

## **Ukraine, 2004**

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**This study is conducted for the Ministry of Economy and European  
Integration of Ukraine**

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## Table of Content

1	Executive Summary	4
2	Cost of Doing Business: Core Component	6
2.1	Research Design and Methodology	6
2.2	Definition of Terms Used in the Report	9
2.3	General Findings	10
2.4	Business Registration	16
2.5	Licensing	22
2.6	Premises: Permits for their Construction, Reconstruction and Use	27
2.7	Regulation of Products and Services	32
2.8	Inspections	34
2.9	Regulation of Prices	43
2.10	Regulation of Contracts	44
3	Administration of Taxes	46
3.1	Research Design and Methodology	46
3.2	Tax Regime	46
4	International Trade	58
4.1	Research Design and Methodology	58
4.2	Export Regime	62
4.3	Import Regime	74

## 1. Executive Summary

1. This study consists of three separate components: Cost of Doing Business (core component), Tax Regime, and International Trade components. Each of the three components utilized separate survey vehicles conducted on independently drawn samples, separate series of focus group meetings and in-depth interviews.
2. Business Environment Study leads to conclusion that overall business environment did not improve in Ukraine during last two years. Mixed results indicate that average costs businesses spend while complying with regulations somewhat decreased, while predictability and instances of unofficial payments increased in Ukraine during last two years. Overall attitudes of Ukrainian businesses point to deterioration of business environment between 2002 and 2004.
3. Two regulatory areas show unarguable improvement over the last two years. These are price regulations and contract monitoring. Licensing and inspections are also close to improvement; however increase in fine coverage for inspections and increase in instances of unofficial payments for both hampered these prospects. Registration regime did not change during last two years. Certification and product permits showed mixed results, while premises related permits showed significant deterioration.
4. The perception among businesses is that over the last years the quality of the business environment in Ukraine has deteriorated significantly. Quantitative data on average does not support such strong deterioration. Negative attitudes of businesses can be partially explained by the side effects of the adoption and enactment of number of codes (Civil, Commercial, Land, Customs). While the declared objective was to streamline regulations, the net effects of the legislative initiatives have been different than anticipated by the Government. These adoptions and enactments decreased stability of regulatory system, made it more complex, and due to inconsistencies, greatly confused everyone. At the same time, expenses associated with regulatory compliance and captured by quantitative surveys either remained the same or decreased.
5. Selective law enforcement and corruption have remained a very significant problem in Ukraine. Moreover, selectivity of law enforcement for political reasons exhibits large regional differences and shows strong correlation with perceived support bases for opposition politicians. Such phenomenon as selective law enforcement is detected mostly through qualitative research methods that assess attitudes and opinions and is evasive for quantitative methods due to infrequent instances of application to average businesses (the term “selective” reflects its nature).
6. The issues of land and construction permits overtook inspections and moved to the most problematic issue areas in Ukraine over the last two years. Problematic natures of these issues are corroborated by qualitative methods and are supported

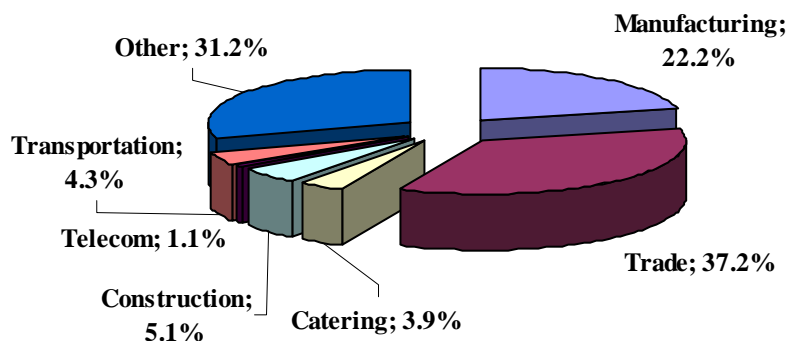
- by quantitative data on costs, time and instances of unofficial payments (used as proxy for overall corruption of the process).
7. Tax regime in Ukraine can be characterized as quite volatile and unpredictable. This is of highest concern for businesses. Volatility depends both, on frequent changes in Laws and on inconsistencies in implementation. Practice of frequent STA explanation letters that reinterpret laws is highly negative. Therefore, moratorium on changing tax laws will not resolve this problem. Such moratorium will be effective if STA will lose formal or informal power to reinterpret laws.
  8. The most problematic tax in Ukraine is VAT due to the problems of its administration and high volume of related accountancy and reporting. This is followed by payroll taxes which are both, prohibitively high (due to Pension Fund payments) and also carry high volume of accountancy and reporting (due to the numerous Social Security Funds). This leads to the necessity of reforming pension system with the purpose of decreasing Pension Fund payments and consolidation of Social Security Funds. Current situation leads to shadow payments of parts of salaries reinforcing need for higher Pension Fund rates.
  9. Ukraine currently is characterized by the elements of total state capture when public and private interests merge and reinforce each other. This is the major cause for not uniformed tax regime and selective law enforcement. This directly correlates with predictability and fairness of tax regime as well as with willingness by businesses to comply with tax obligations. If not resolved, this phenomenon might negate all other reforms of Ukrainian tax regime.
  10. Both qualitative and quantitative research methods indicate that the greatest problems faced by Ukrainian exporters in terms of dealing with administrative characteristics of export regime relate to the issues of VAT return and clearing of Customs. Ukrainian businesses that are engaged in export operations face significantly more problems at home then abroad. As for non-domestic issues the only important one is promoting capacity for effective protection of Ukrainian companies in courts abroad.
  11. Main problems that need to be addressed at the Governmental level in the area of import regime relate to Customs especially corruption and arbitrary interpretation of laws by Custom officials.

## 2. Cost of Doing Business: Core Component

### 2.1. Research Design and Methodology

The quantitative survey part was conducted on nationally representative sample of 2,100 businesses in all regions of Ukraine. The sample is representative of the legal forms assumed by Ukrainian businesses, their geographic location and size. The sample is based on the statistical information from the State Tax Administration. Between 60 and 153 companies were surveyed depending on the number of active businesses in these regions. The survey was conducted among all types of businesses except primary agricultural producers and banks. Sectors in which polled companies operate are presented in Picture 1. Like in 2002, when similar research was conducted in Ukraine under the auspices of the World Bank, greatest share of polled companies operate in the field of trade. Type of activity was not used for sample design, however distribution of companies by this indicator in 2002 and in the current research is strikingly similar.<sup>1</sup>

**Picture 1 Sample distribution by sector of economy**

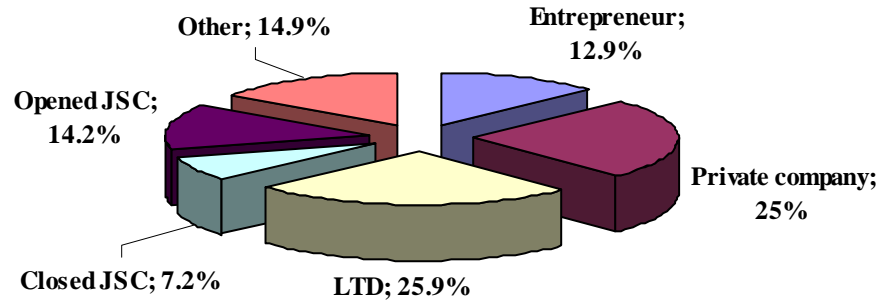


By legal-organizational form the distribution is presented in Picture 2. Greatest share of sampled companies are LTDs that are closely followed by private companies.

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<sup>1</sup> For the full Report on Cost of Doing Business in Ukraine, 2002, Research conducted by Andrii Palianytsia for the World Bank, please see [http://www-wds.worldbank.org/servlet/WDS\\_IBank\\_Servlet?pcont=details&eid=000160016\\_20031205153539](http://www-wds.worldbank.org/servlet/WDS_IBank_Servlet?pcont=details&eid=000160016_20031205153539)

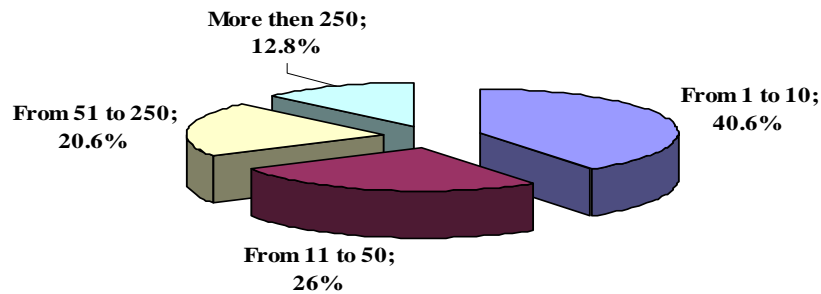
**Picture 2 Sample distribution by legal-organizational form**



By ownership, 4.6% of responding companies are fully state owned, further 6.3% reported various shares of state property. There are also 10.1% fully foreign owned companies with further 3.6% reported various shares of foreign ownership.

Picture 3 illustrates size of surveyed companies by the number of employees.

**Picture 3 Sample distribution of exporting companies by the number of employees**



All data was collected during face to face interviews conducted by trained interviewers according to designed and piloted questionnaire. All interviews were conducted with management of responding companies (director or deputies in charge of export operations). 10% external quality control was ensured. Statistical analysis was done using SPSS program.

Four Focus Groups were conducted in different localities in Ukraine in May of 2004. These included Kherson, Kharkiv, Lviv, and Kyiv regions. All FG were conducted with 10-15 exporters or importers using designed template. Template entries were read and after short discussion data was entered only if consensus was established during each FG on each template entry. Mean data from four FG is presented in the report.

## 2.2. Definition of Terms Used in the Report

**Official fees** – are fees paid to the budget and prescribed by corresponding legal acts. These also include fines.

**“Voluntary contributions”** – payments made by businesses in currency or goods and services to various funds or for subscription of periodicals. These payments are legal, although motivation to make them frequently if not always relates to implicit or explicit suggestions by regulatory agencies to make them.

**Unofficial payments** – are bribes paid in currency or in-kind contributions to specific officials. Data received on this indicator in most cases is lower than actual instances of unofficial payments. Its utility lies mostly in comparative analysis.

**Expertise fees** – are official fees paid to third parties for independent analysis and expertise. These are most frequently used in the systems of permits and licensing. In some instances independent expertise is prescribed by laws or licensing conditions.

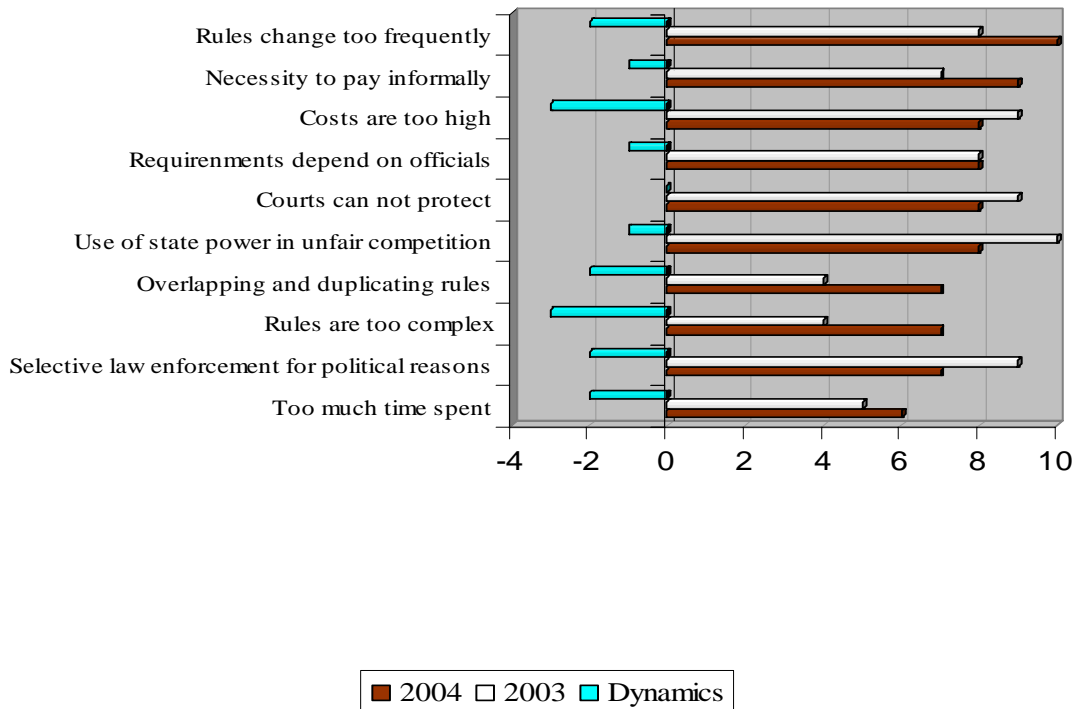
**Payments to lawyers** – are official voluntary payments to lawyers or intermediaries for legal aid or facilitation of the process. It is not excluded that some portion of these fees is eventually paid by such intermediaries as unofficial payments to officials.

**Coverage** – is % of companies reporting at least one instance of application of specific regulation per year.

### 2.3. General Findings

Business environments everywhere can be characterized by certain general negative elements such as contradictions in laws, corruption etc. Figure 4 presents a focus group evaluation of the current regulatory regime in Ukraine and its evolution by focusing on the quality of the regulatory framework and the enforcement. Focus groups participants were asked to evaluate stated negative characteristics of business environment using 10-point scale. These data enables two-fold comparison with situation in past years. First, FG participants themselves provided perception of dynamics (shown as dynamics in Picture 4). In addition to this, similar FGs were conducted in Ukraine in 2003 in the framework of the World Bank Business Environment Early Warning System in Europe and Central Asia region. This data provides an opportunity to observe change in perception of business environment by Ukrainian companies.

**Picture 4 FG Evaluation of characteristics of business environment (using 10-point scale where 10 is severe problem and 1 is no problem) and its dynamics (- 5 is the largest negative change and +5 - largest positive change during the last year)**



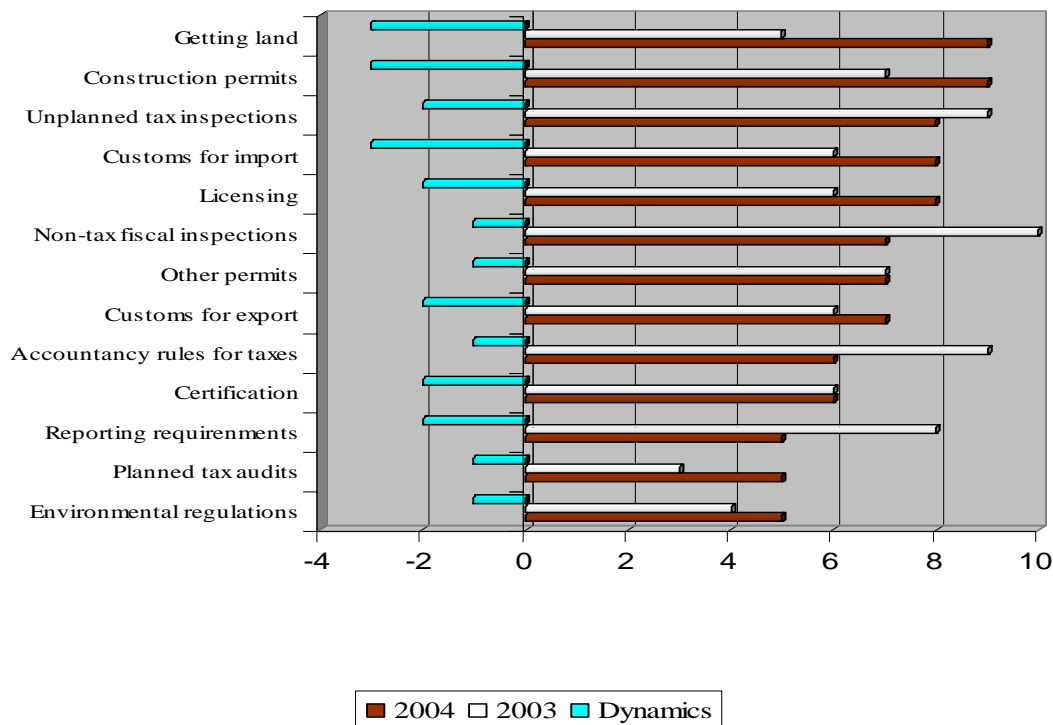
Stability of the regulatory system as well as substance and clarity of laws and regulations worsened over the last year. Participants referred to the newly adopted Codes (Civil, Commercial, Customs, and Land) and changes in accounting system as the major causes behind the increasing number of confusing requirements. Moreover, the enforcement of

the regulatory norms deteriorated, as the frequency of unofficial payments increased. Respondents identified two reasons behind the increase: (a) forthcoming presidential elections; and (b) increasing profits of enterprises and greater availability of resources.

As the Picture 4 indicates, the perception of selectivity of law enforcement for both economic and political reasons somewhat decreased in 2004, yet there is still a strong feeling that the situation is deteriorating. To that end, it is very important to note that there are significant regional differences in perceptions when it comes to selective law enforcement for political reasons. Focus groups in Kyiv and Lviv presented a much more negative evaluation than groups in Kharkiv and Kherson (10 and 8 as compared to 5 and 6). This can be explained by the significantly larger proportion of businesses that support opposition leaders in both Kyiv and Lviv – the fact that can aggravate the differences in treatment in particular in pre-election year.

Picture 5 illustrates the perceived intensity of the regulatory problems and its annual dynamics by regulatory areas.

**Picture 5 FG Evaluation of regulatory areas (using 10-point scale where 10 is severe problem and 1 is no problem) and its dynamics (- 5 is the largest negative change and +5 - largest positive change during the last year)**



The indicators have deteriorated in most of the areas under investigation. The greatest deterioration can be found in the areas of land and construction permits - both in the

comparison between 2004 and 2003 and the perception of dynamics. Focus group participants noted the increased requirements to receive these permits. The requirement of the new Land Code to change the status of business land lots from “permanent use” to “rented” or “purchased” till January 1, 2005 seems to explain these difficulties.

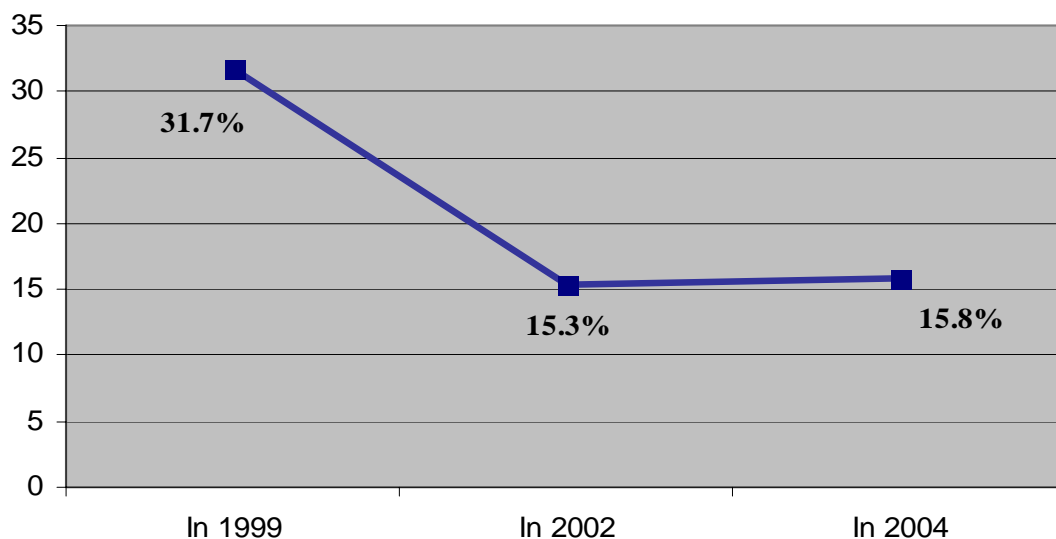
There has also been perceived deterioration regarding non-tax inspections. Although in comparison with other areas it moved from being one of the most problematic as it was in 2003. Respondents still identify a large number of organizations besides tax agency allowed by law to conduct fiscal inspections. Focus group participants also noted that even agencies that do not have a legally defined function to conduct such inspections did engage in these activities. All these non-tax inspections lead to additional amounts of fines imposed on businesses.

Unplanned tax inspections likewise remain a problematic area, virtually the same over the last year, yet with a perception of deterioration. On the other hand, planned tax inspections represented the least of the problems in 2004; only the Lviv region reports deterioration which probably relates to selective law enforcements issue described above.

Finally, focus group respondents were consistent in pointing to a deterioration in licensing, related mostly to increased costs and waiting time for alcohol and tobacco retail trade licenses and to the requirements to obtain these licenses from national agencies.

One the most commonly used general indicator of the business environment is % of time management (director, deputy director, chief accountant) spends with officials while fulfilling regulatory obligations. Picture 6 illustrates dynamics of this indicator as reported by comparable surveys in Ukraine in 1999, 2002 and 2004.

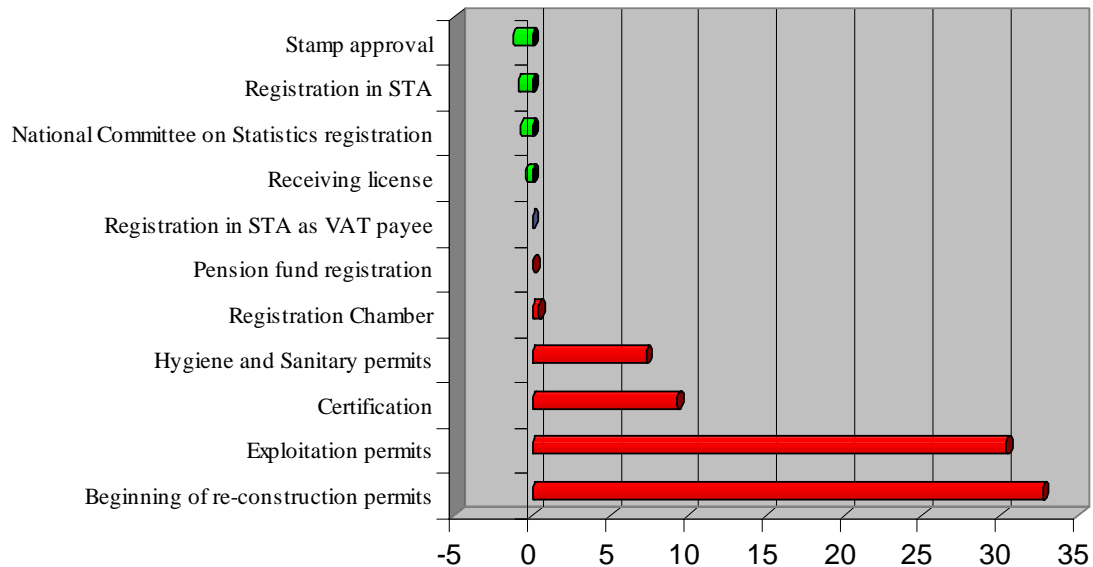
**Picture 6 % of time management spends with officials dealing with regulations**



Between 1999 and 2002 this indicator significantly decreased, while between 2002 and 2004 it remained almost the same with slight increase. It reflects and corroborates other findings described below that overall business environment in Ukraine after a number of years of steady improvements stopped these improvements and probably started to deteriorate in 2003-2004.

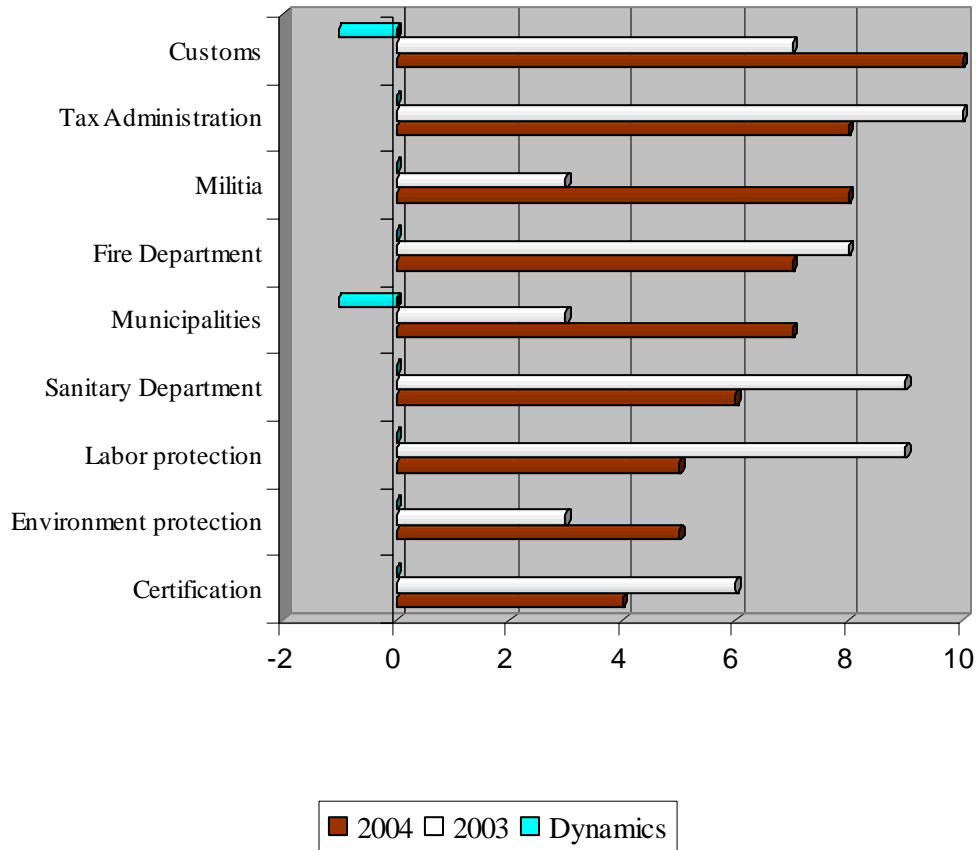
Difference in time needed to register and obtain various permits in 2002 and 2004 is illustrated on Picture 7. While for registration and licensing it remained virtually unchanged and even decreased, for construction permits and goods certification and permits it significantly increased. This increase was offset by smaller number of inspections therefore, in result, businesses dealt with authorities almost the same share of their time both in 2002 and 2004.

**Picture 7 Difference in time spent to register and obtain permits (increase to the right, decrease – to the left) in days (quantitative data)**



Picture 8 presents the data on the corruption level among state agencies involved in different aspects of regulatory activity as evaluated by focus groups. Please note that this is perception data and it reflects opinion of focus group participants not about the instances of unofficial payments, but rather overall corruption levels in stated agencies.

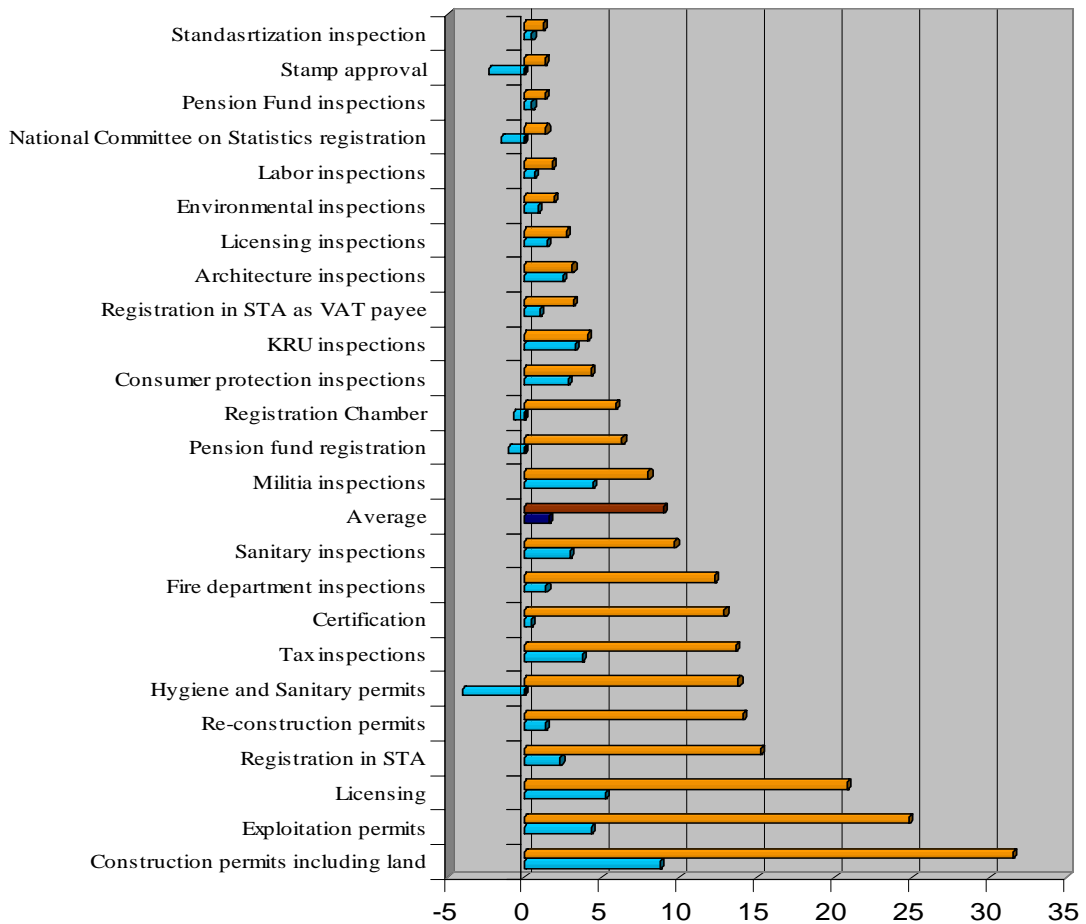
**Picture 8 FG Evaluation of corruption levels (using 10-point scale where 10 is severe problem and 1 is no problem) and its dynamics (- 5 is the largest negative change and +5 - largest positive change during the last year)**



The information in Picture 8 is consistent with an increasing frequency in informal payments, indicated by the survey: the perception of corruption in three law enforcement agencies, namely customs, tax administration and police fared worse than last year, particularly in the police. In 2004 the corruption was sensed to be significantly higher also among municipalities that became largely responsible for renting and selling land lots to businesses.

Picture 9 represents data from the survey on actual instances of unofficial payments in 2004 and dynamics of this indicator between 2002 and 2004. Land and construction permits fared worse than other regulatory issues.

**Picture 9 Instances of unofficial payments in 2004 and dynamics of this indicator between 2002 and 2004**



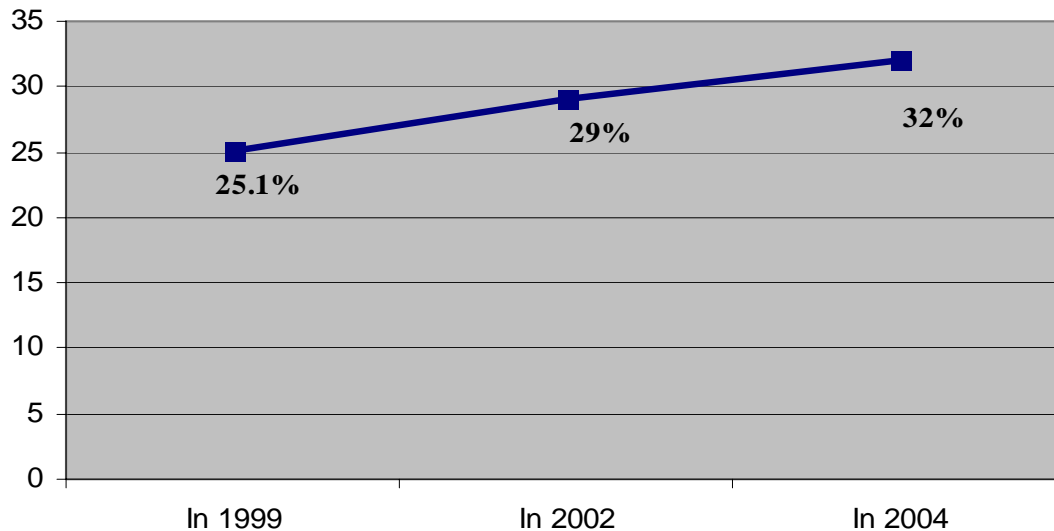
Change in unofficial payments instances between 2002 and 2004 Unofficial payments in 2004

## 2.4. Business Registration

Before beginning of their activities, Ukrainian entrepreneurs must register their businesses. There are three components to such process – (1) pre-registration that includes preparation of all necessary documentation and notarizing them; (2) actual state registration at local executive bodies; (3) post-registration activities that include registration with State Tax Administration, Statistics agencies, Pension and various Social Security Funds, registration of stamps. Current research reflects situation before new Law on Registration was implemented (prior to July 1, 2004).

Availability of intermediaries, relatively well established and stable process of registration lead to quite steady increase in usage of intermediary services between 1999 and 2004 (see Picture 10).

**Picture 10 % of respondents that used intermediaries in registration**



Time that it took to be fully legalized while using intermediaries demonstrates striking similarity over last 5 years. In 2004 it is 17.7 days, while in 2002 it was 18.7 days and in 1999 – 17 days. Similarly cost for such services did not change much. In 2004 it is \$171.5, while in 2002 it was \$148.8 and in 1999 – \$181. Such data illustrates quite unique for Ukrainian regulations stability between 1999 and 2004.

All data on registration procedures that is described below is calculated while excluding respondents that used intermediaries. On average, Ukrainian businesses spent 30.6 days for overall registration process in 2004. This is somewhat shorter period of time then 34.9 days recorded in 2002. Distribution by agencies remained the same as in 2002 and 1999 with most time spent in Registration Chamber and Ministry of Interior affairs. Like data for companies that used intermediaries, registration duration is virtually unchanged between 1999 and 2004 both overall and by specific agencies (see Table 1).

**Table 1 Duration of registration process by agency**

	Time spent, days (2004)	Time spent, days (2002)	Time spent, days (1999)
Registration Chamber	11.1	10.7	11.6
National Committee on Statistics	3.4	4.1	4.4
Tax Administration	5.2	6.1	4.4
Tax Administration as VAT payee	5.0	5.0	3.6
Ministry of Interior Affairs (stamps)	7.1	8.3	4.8
Pension Fund	2.2	2.1	3.1
Casualty Social Insurance Fund	2.1	2.1	2.2
Unemployment Social Insurance Fund		1.9	
Temporary Disability Social Insurance Fund		1.9	
<b>Overall</b>	<b>30.6</b>	<b>34.9</b>	<b>26.4</b>

Cost of registration process somewhat decreased between 2002 and 2004 from \$64.3 to \$50.3, while instances of unofficial payments increased from 3.6% to 6.4% (Table 2).

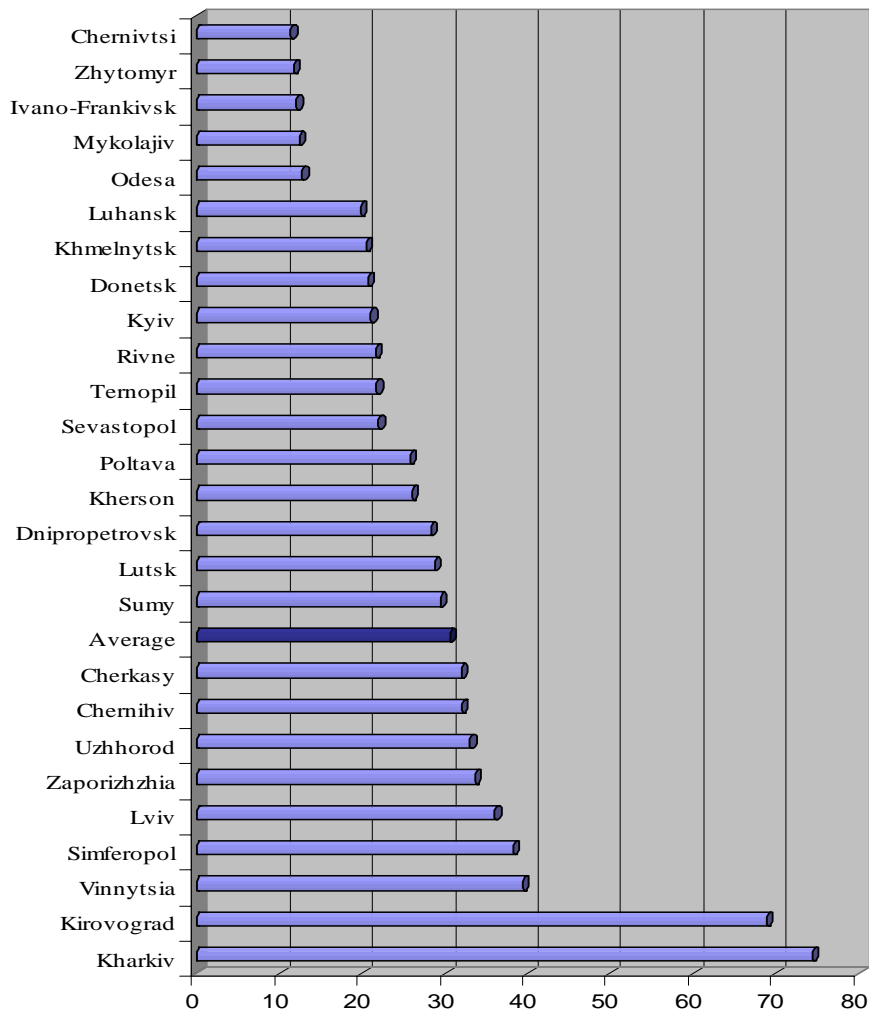
**Table 2 Costs of the registration process by agency in 2002 and 2004**

	Official fees				“Voluntary” Contributions				Unofficial payments							
	%		\$		%		\$		%		\$					
	04	02	04	02	04	02	04	02	04	02	04	02				
Public Notary	95.3	97.2	23.6	30.8	5.1	2.8	23.2	-	2.0	5.4	24.2	31.3				
Registration Chamber	97.0	95.8	18.4	21.3	8.4	5.9	6.0	34.7	5.9	6.6	35.8	37.0				
National Committee on Statistics	92.7	91.7	8.2	7.5	7.5	2.4	11.7	-	1.4	2.9	-	7.4				
Tax Administration	77.0	77.5	12.6	12.5	17.8	12.4	16.5	-	15.2	12.9	16.9	14.9				
Tax Administration as VAT payee	88.0	81.7	8.7	9.6	3.3	4.2	-	6.8	3.2	2.2	-	-				
Ministry of Interior Affairs (stamps)	98.7	97.2	21.3	21.5	1.3	5.6	-	-	1.3	3.6	-	-				
Pension Fund	59.3	54.5	6.2	14.5	17.2	13.6	5.3	-	6.3	7.3	-	-				
Casualty Social Insurance Fund	49.3	45.6	14.2	29.1	28.2	18.8	5.7	8.5	3.8	12.1	-	-				
Unemployment Social Insurance Fund		42.4		16.8									19.0	1.7	8.9	-
Temporary Disability Social Insurance Fund		36.3		11.5									20.0	-	11.4	-

Although, if analyzed by agencies, registration costs as well as instances of “voluntary” and unofficial payments, also exhibit significant stability. Like in 2002, in 2004 most instances of “voluntary” contributions occurred with various Social Funds that are closely followed by Tax Administration and Pension Fund. In both times, Tax Administration ranked worse than other agencies in % of respondents that claimed that they paid unofficially. Services of registration intermediaries saved businesses on average 12.9 days and necessity to visit numerous agencies for additional cost of \$121.2 in 2004.

Picture 11 shows time associated with registration procedures by region.

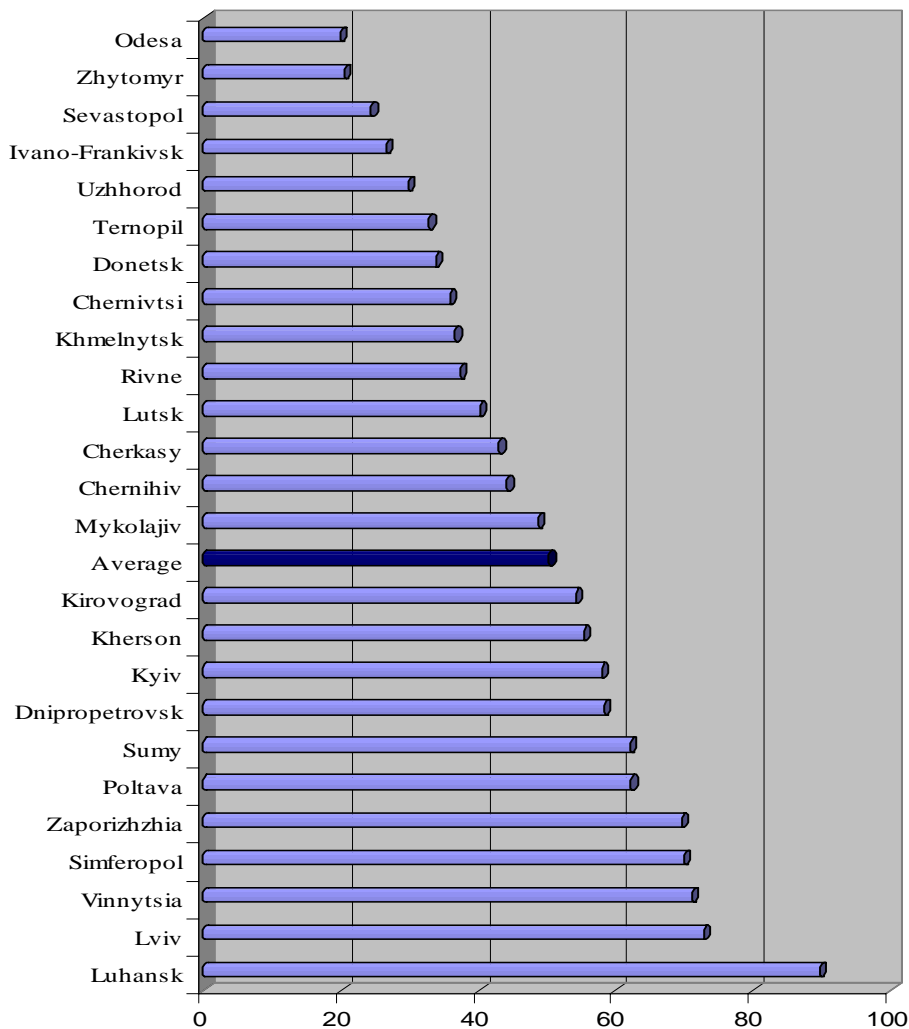
**Picture 11 Registration time by region, days**



There are clearly two outliers with respondents reporting almost 70 days – Kirovograd and Kharkiv. Unfortunately both these cities reported longer then average time in 2002 and only further increased it in 2004. At the same time there are 5 cities that report around 10 days necessary for the whole registration process. Surprisingly, two of these cities, namely Odesa and Chernivtsi used to have longest registration time in 2002. Ivano-Frankivsk and Zhytomyr also managed very significant progress.

Picture 12 shows costs associated with registration procedures by region.

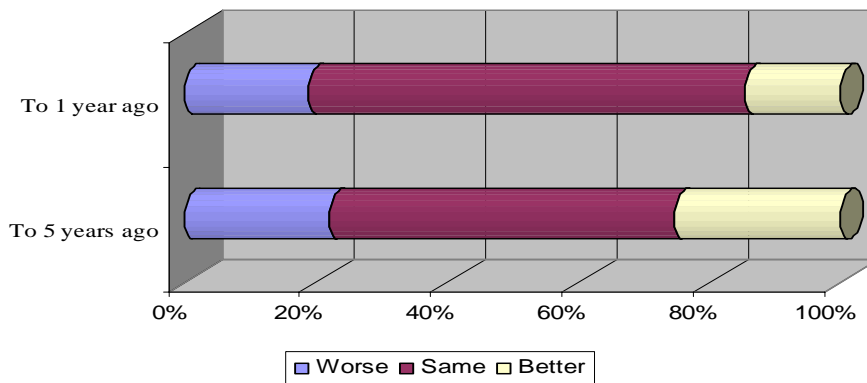
**Picture 12 Registration costs by region, \$**



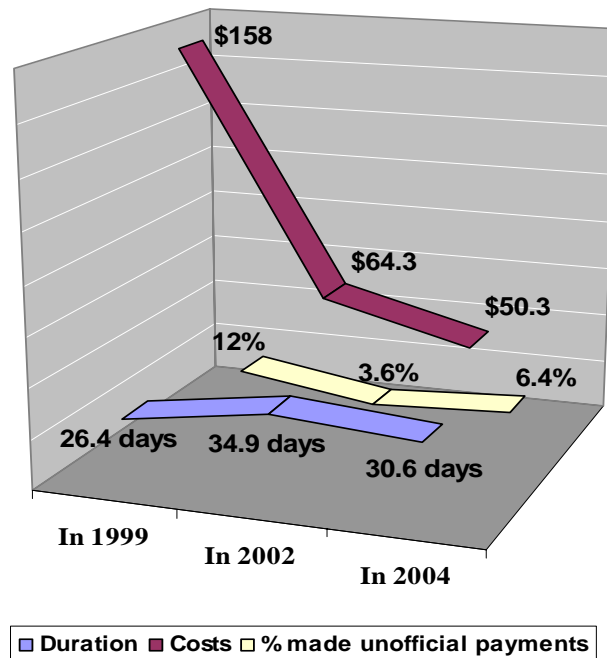
Like with registration time, Odesa made the greatest improvement in registration costs between 2002 and 2004. Lviv, Zaporizhzhia and Poltava remained the most costly cities to be registered in during both surveys. Luhansk is the city that deteriorated in this indicator more than others. Overall, Odesa, Zhytomyr and Ivano-Frankivsk have best registration regime in Ukraine in terms of time and costs in 2004.

Respondents' perception of registration regime changes over the last 5 (see Picture 13) years reflects overall stability of major indicators described above and presented in Picture 14.

**Picture 13 Perception of dynamics of registration regime in comparison to 1 and 5 years ago (in % of respondents)**

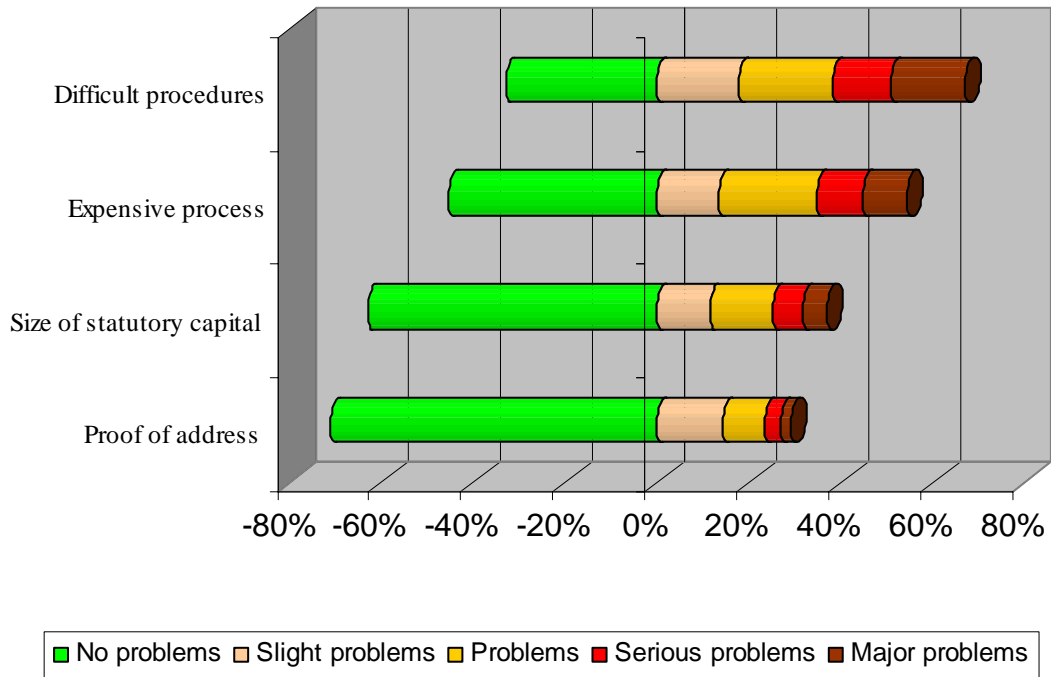


**Picture 14 Major registration indicators in 1999, 2002, and 2004**



Finally, when asked to evaluate on the 5-point scale difficulties associated with registration, like in 2002, respondents identified difficulties in procedures as most problematic issue which is followed by expenses (see Picture 15).

**Picture 15 Evaluation of possible problem areas on the 5-point scale in % of respondents**

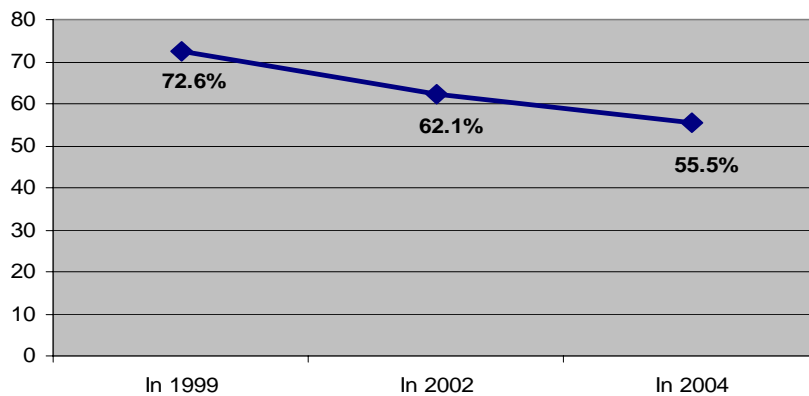


## 2.5. Licensing

Before beginning their activities some businesses also must apply for and receive licenses. According to the Law, a license is a document issued by the authorized executive body that gives right for a business to conduct specified type of activity. In other words license is permit to engage in certain types of activities. License coverage or % of companies that report at least one license is important indicator on the scope of state regulations of business activities.

In 2004 survey, 55.5% of businesses reported at least on license in Ukraine. This represents steady decline in licensing coverage since 1999 (see Picture 16).

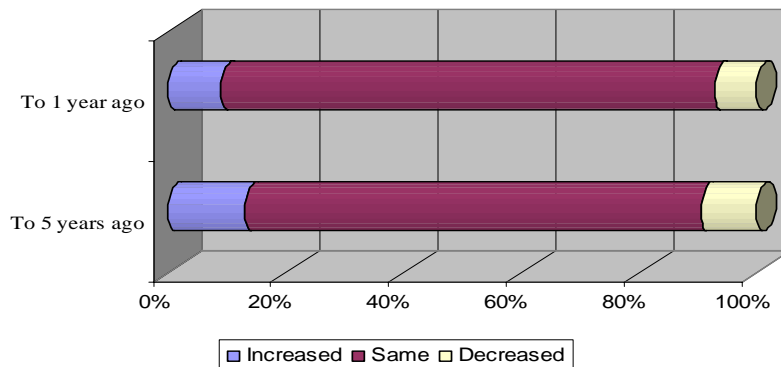
**Picture 16 Licensing coverage in between 1999 and 2004**



Like it was reported in 2002, decrease in licensing coverage can be caused by more businesses starting activities in non-licensed areas.

Those businesses that reported licenses have on average 1.9 licenses in 2004 which is almost the same as 1.7 and 1.6 licenses reported respectively in 2002 and 1999. This is fully corroborated by perception data (see Picture 17). Most businesses believe that number of licenses did not change over last years.

**Picture 17 Perception of change in number of licenses**



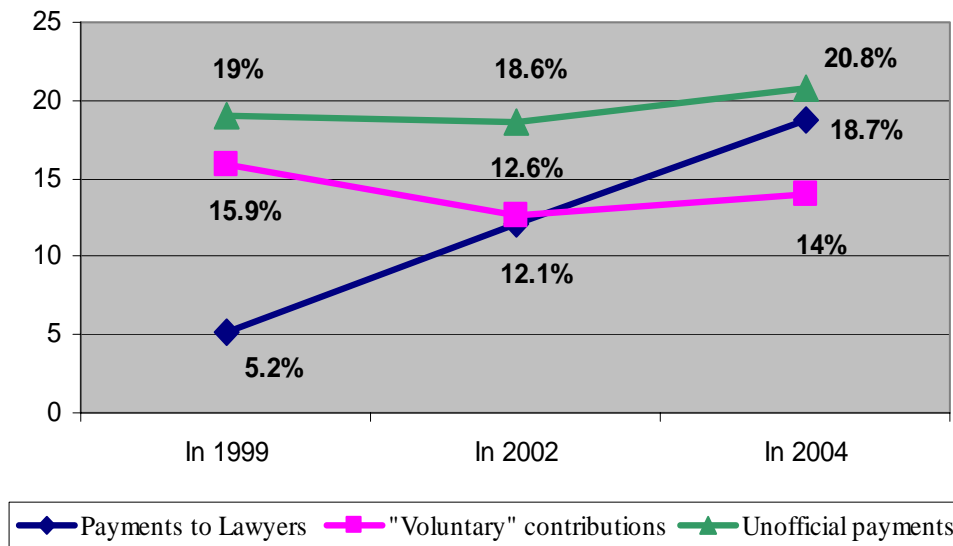
Respondents reported that average term of validity of one license is 2.6 years which is slightly more than 2 and 2.2 years reported in 2002 and 1999 respectively. Time necessary to receive one license is 20.6 days which is unchanged from 21 days that were necessary in 1999. This process costs \$163.8 in 2004 which represents significant decrease from previous years. Overall cost distribution by the types of expenses and comparison with 1999 and 2002 is presented in Table 3.

**Table 3 Payments for licenses**

	% Paid			\$ Paid		
	2004	2002	1999	2004	2002	1999
Official fees	-	-	-	139.0	226.3	162.0
Expertise fees	27.7	29.8	17.6	74.8	157.7	119.0
Notary fees	36.6	33.1	33.0	20.7	34.3	25.3
Payments to Lawyers	18.7	12.1	5.2	59.6	144.3	71.0
“Voluntary” contributions	14.0	12.6	15.9	31.9	314.0	107.0
Unofficial Payments	20.8	18.6	19.0	73.6	264.7	140.0
<b>Overall</b>				<b>163.8</b>	<b>252.3</b>	<b>236.8</b>

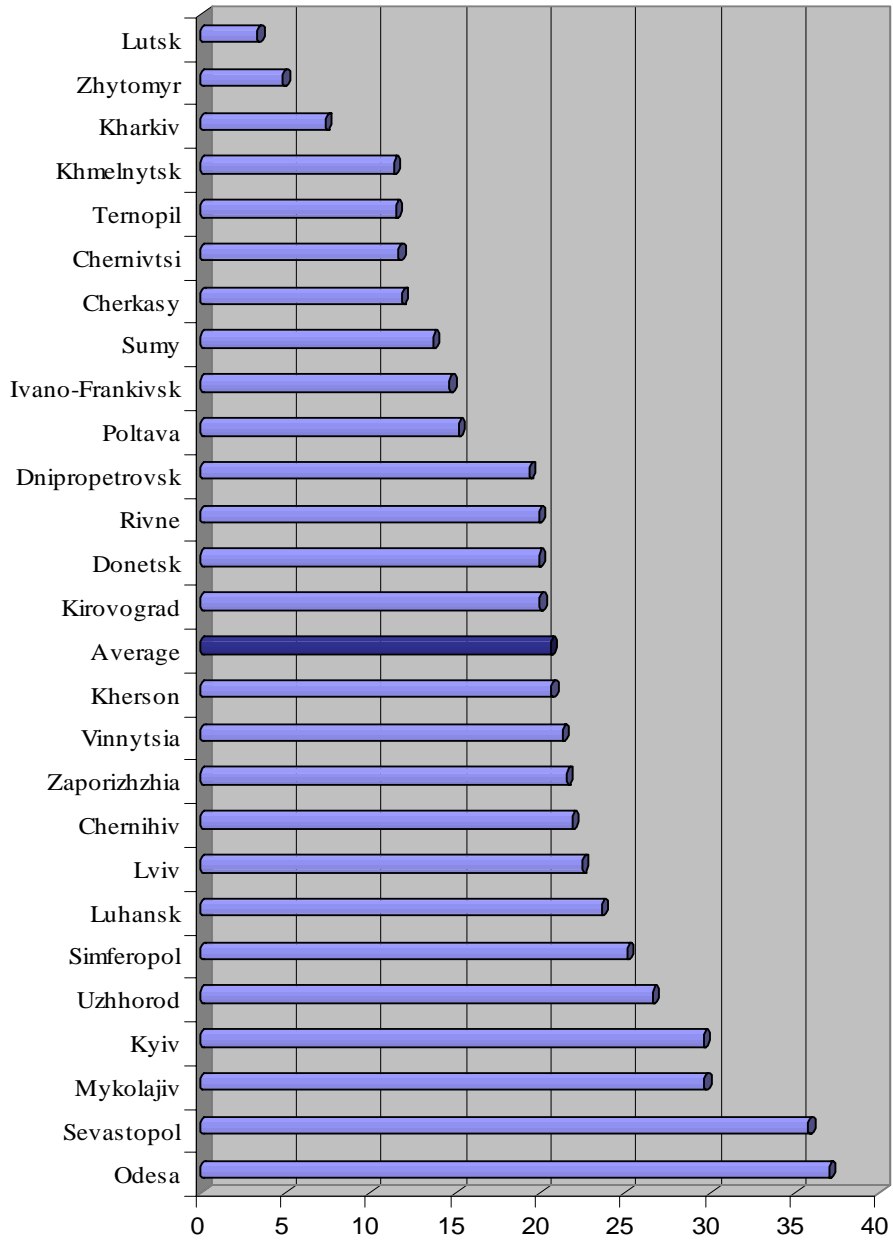
Payments to lawyers show steady increase in coverage over the last 5 years. Dynamics of this coverage as well as “voluntary” contributions and unofficial payments is presented on Picture 18.

**Picture 18 Payments to lawyers, “voluntary” contributions, and unofficial payments coverage in 1999 – 2004 (in % of respondents)**

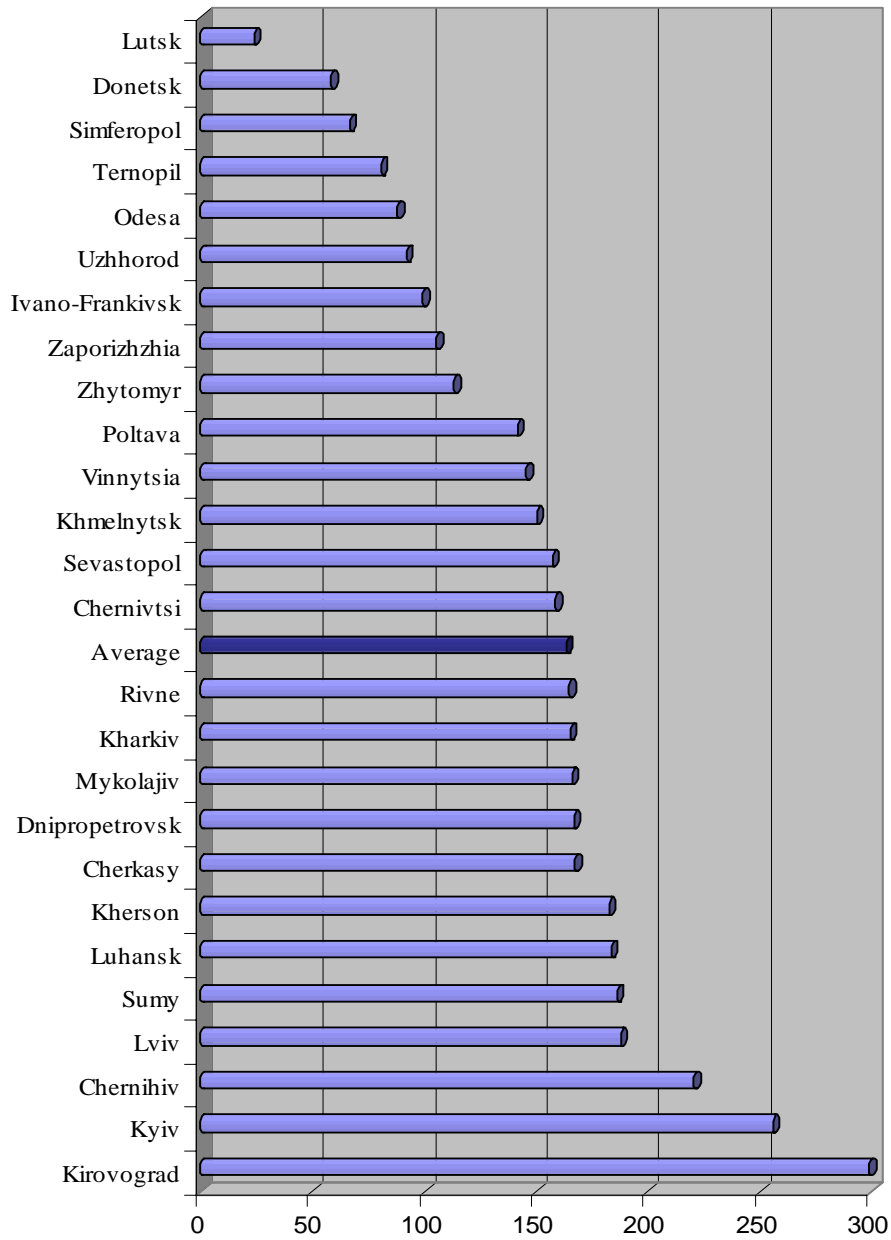


Regional distributions by the time needed to obtain one license and the costs of the process are presented on Pictures 19 and 20. Odesa and Sevastopol are two clear outliers that have the longest time needed to obtain licenses.

**Picture 19 Time needed to obtain one license by region (in days)**



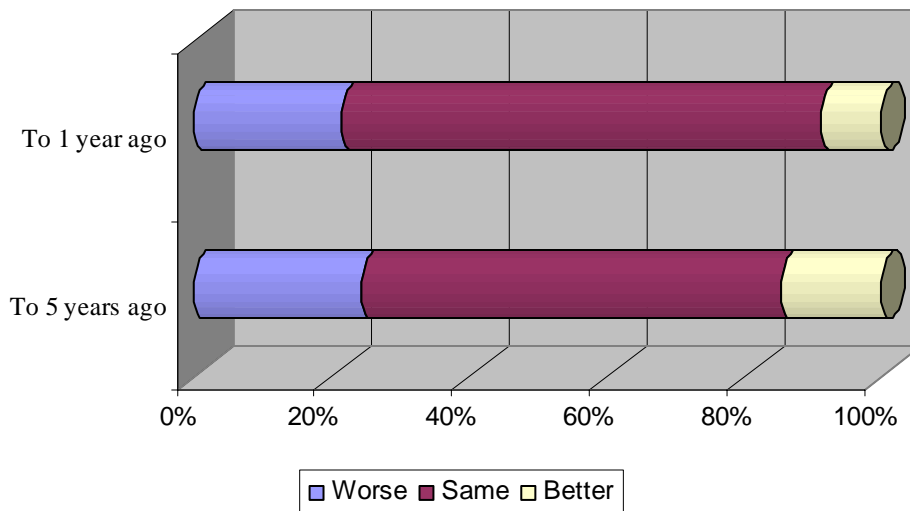
**Picture 20 Licensing costs by region (in \$)**



In terms of costs, exactly like it was in 2002, Kirovograd and Kyiv reported greatest costs. Lutsk reported the best licensing regime in terms of both time and costs. One, however must be careful in making far reaching conclusions based on regional data distribution. Samples in regions are relatively small and in some cases they can be skewed towards companies that require easier licenses. Thus, data can illustrate such issues in addition to actual policies effects. The cases of Kirovograd and Kyiv are different, however. They report worst results for costs in both surveys: in 2002 and in 2004.

Relatively steady results in actual indicators are also reflected in perception of change by respondents. Quite clearly according to them there was no improvement in 2004 in the regulatory issues related to licensing regime (see Picture 21).

**Picture 21 Perception of dynamics of licensing regime in comparison to 1 and 5 years ago (in % of respondents)**



## 2.6. Premises: Permits for their Construction, Reconstruction and Use

Availability of premises is necessary part in conducting business. Many businesses have more then one premise were they are able to conduct diverse operations such as office work, manufacturing, retail trade, etc. Businesses can use premises if they either own them or rent (use) from other state, municipal or private entities. In most cases in Ukraine businesses own their premises (see Table 4).

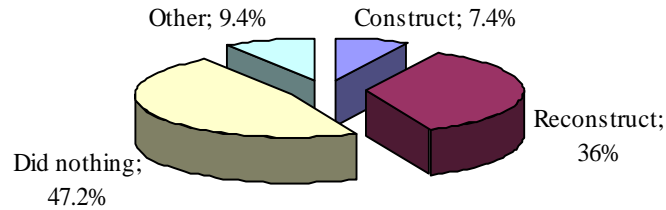
**Table 4 Types of premises used by respondents in %**

	Use such premises	Private property		Rent from state (municipality)		Other rent
	2004	2004	2002	2004	2002	2004
Office	74.1	48.8	43.7	19.9	24.2	31.3
Premises for retail trade (food)	17.0	58.8	59.3	20.8	20.7	20.5
Premises for retail trade (other)	20.4	56.4	46.1	17.4	22.6	26.2
Premises for catering	12.2	65.3	67.1	19.6	23.7	15.1
Premises for services	19.1	51.6	44.4	25.4	31.7	23.0
Premises for manufacturing	41.1	64.4	59.7	17.6	21.6	18.1
Premises for storage	52.2	60.9	53.6	16.8	20.9	22.3
Other	15.2	57.8	55.8	17.0	22.0	25.3

By comparing data from 2002 and 2004 one can observe that there was steady although relatively slow process of privatization of premises in Ukraine. Only premises for retail trade in food products did not decrease share of state or municipal ownership. At the same time, share of owned premises increased except for retail trade in food products and catering. In catering there was probably a process of privatization by intermediaries with subsequent renting. One can explain this phenomenon by the trend for new small businesses to start operations mostly in retail trade or catering. Such businesses do not have sufficient funds to privatize their premises.

Before full usage, majority of businesses either reconstructed (remodeled) their premises or did not do anything to them (see Picture 22). Only 7.4% of businesses constructed their premises. This is sharply higher then 2% reported in 2002.

**Picture 22 What businesses did before using premises**



Before construction, Ukrainian companies must apply for land usage permit. In addition to this construction plans must be approved and various additional permits received. The later applies also to businesses that renovate or remodel their premises. After all work is finished, or in cases of moving into premises even if no work was conducted, in most cases various exploitation permits are needed. These include permits from such agencies as fire, sanitary inspections and other.

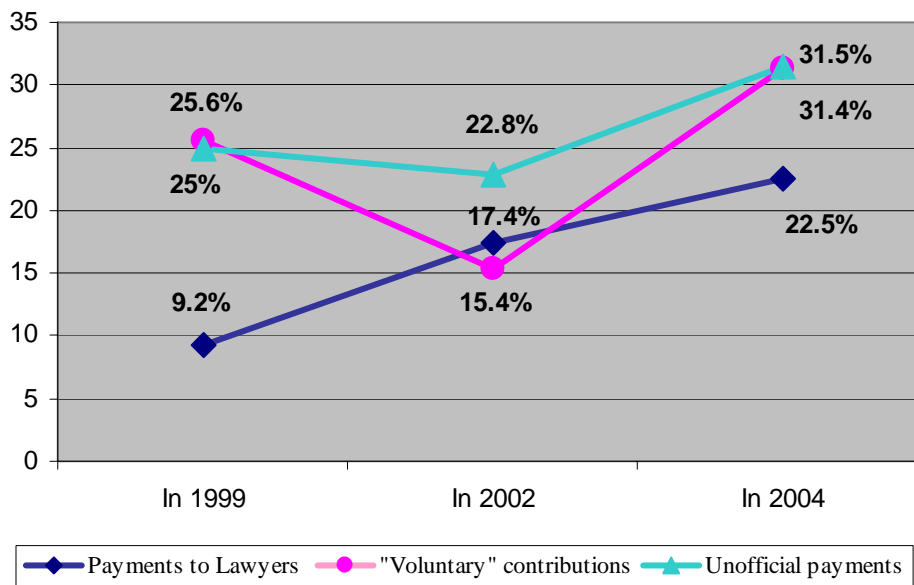
In order to begin construction, Ukrainian businesses spent on average 116.9 days securing various permits including use of land permit and approval of the work plan. This process also costs \$547.8 in 2004 of which \$218.7 is paid as bribes and “voluntary” contributions. This represents increase from \$437.1 reported in 2002. Overall cost distribution by the types of expenses and comparison with 1999 and 2002 is presented in Table 5.

**Table 5 Payments for permits necessary for the beginning of construction**

	% Paid			\$ Paid		
	2004	2002	1999	2004	2002	1999
Official fees	65.1	54.0	-	336.2	169.6	159
Expertise fees	50.4	45.5	34.5	304.2	162.3	44.4
Notary fees	49.5	35.5	24.8	35.2	35.5	25.0
Payments to Lawyers	22.5	17.4	9.2	111.9	398.9	121.3
“Voluntary” contributions	31.4	15.4	25.6	159.1	142.5	670.0
Unofficial Payments	31.5	22.8	25.0	235.8	248.7	634.0
<b>Overall</b>				<b>547.8</b>	<b>437.1</b>	<b>668.0</b>

Expertise fees, notary fees, payments to lawyers show steady increase in coverage over the last 5 years. Actual expenses did not change for notary fees, significantly increased for expertise and decreased for lawyer services. Most interesting, however, is the issue of coverage for “voluntary” contributions and unofficial payments (see Picture 23).

**Picture 23 Payments to lawyers, “voluntary” contributions, and unofficial payments coverage in 1999 – 2004 (in % of respondents)**



Both of these indicators showed improvement in 2002 and quite significant deterioration in 2004. In terms of actual expenses, there was no change between 2002 and 2004 for “voluntary” contributions and unofficial payments.

During the construction process, government and municipal agencies have right to inspect actual construction process. In 2004, 21.8% of respondents reported such inspections. This represents decrease from 28.2% reported in 2002 and continuation of decrease trend from 1999 when such instances were reported by 40.7% of respondents. It is possible that such decrease is caused by the greater number of construction sites in Ukraine in 2004.

Inspection of construction process on average costs \$354.3 in 2004. This represents significant increase from \$185.8 reported in 2002 and reverses decreasing trend that occurred between 1999 and 2002 (in 1999 this indicator was \$508).

Similarly as with construction, when businesses reconstruct their premises they also obtain permits. 72.9% of respondents reported that they had to obtain permits to begin reconstruction process. On average in 2004 it took 42.9 days and \$239.3 to obtain such permits. This is significantly lower than in 2002 when this process took \$442.8. Overall cost distribution by the types of expenses and comparison with 2002 is presented in Table 6.

**Table 6 Payments for permits necessary for the beginning of reconstruction**

	% Paid		\$ Paid	
	2004	2002	2004	2002
Official fees	43.6	37.0	181.8	191.2
Expertise fees	33.2	29.3	93.8	144.8
Notary fees	29.2	21.5	41.0	29.5
Payments to Lawyers	18.1	12.1	72.8	84.8
“Voluntary” contributions	14.1	12.8	59.5	174.7
Unofficial Payments	19.0	21.7	80.1	145.4
<b>Overall</b>			<b>239.3</b>	<b>442.8</b>

Both, instances of “voluntary” contributions and unofficial payments remained mostly unchanged between 2002 and 2004. Instances of all other payments somewhat increased which means that the process despite becoming less expensive became more administratively complex.

As written above, there are also exploitation permits that issued before premises are occupied. Receiving such permits in 2004 took on average 37.2 days. This constitutes significant increase from 6.8 days reported in 2002 and even from 20.2 days reported in 1999. However in terms of costs it took businesses \$241.2 in 2004 to obtain such permits which is lower then \$488 in 2002 and \$390 in 1999. Overall cost distribution by the types of expenses and comparison with 1999 and 2002 is presented in Table 7.

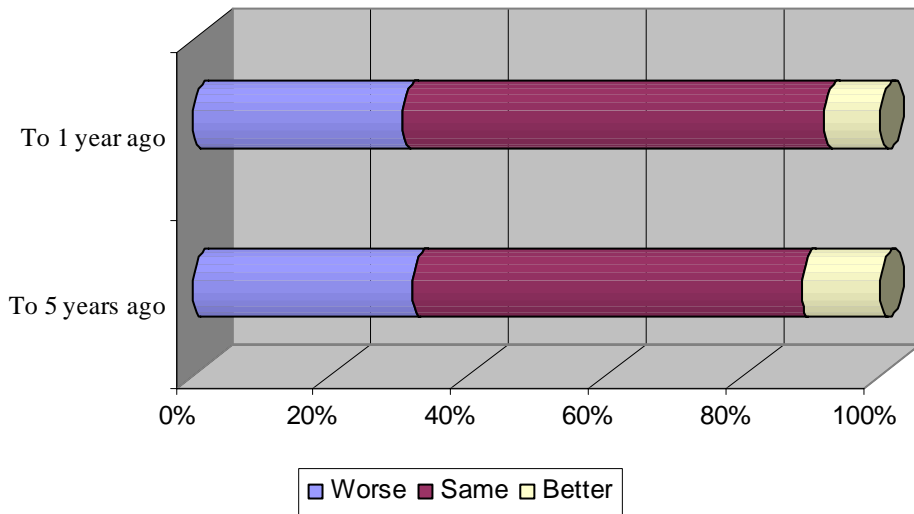
**Table 7 Payments for exploitation permits**

	% Paid			\$ Paid		
	2004	2002	1999	2004	2002	1999
Official fees	55.0	34.5	-	161.4	216.1	451.0
Expertise fees	39.4	20.7	22.7	163.5	118.3	49.0
Notary fees	23.8	13.1	25.3	25.6	76.1	48.0
Payments to Lawyers	18.8	9.0	9.7	56.6	112.4	44.0
“Voluntary” contributions	20.4	9.7	24.4	48.5	147.4	151.0
Unofficial Payments	24.8	20.5	21.3	246.9	155.6	82.0
<b>Overall</b>				<b>241.2</b>	<b>488.0</b>	<b>390.0</b>

Similarly as with pre-reconstruction permits, the instances of all official payments increased in 2004 and continue trend of increases from 1999. This also means that the process of receiving exploitation permits despite becoming less expensive became more administratively complex. There is also one alarming finding that illustrates reversal of positive trend in decrease of instances of “voluntary” payments between 1999 and 2004. Like in some other indicators described above there is pronounced “dip” when such instances increased in 2004.

Mixed results in actual indicators are also reflected in perception of change by respondents. Quite clearly according to them there was no improvement in 2004 in the regulatory issues related to premises permits (see Picture 24).

**Picture 24 Perception of dynamics of permits regime in comparison to 1 and 5 years ago (in % of respondents)**

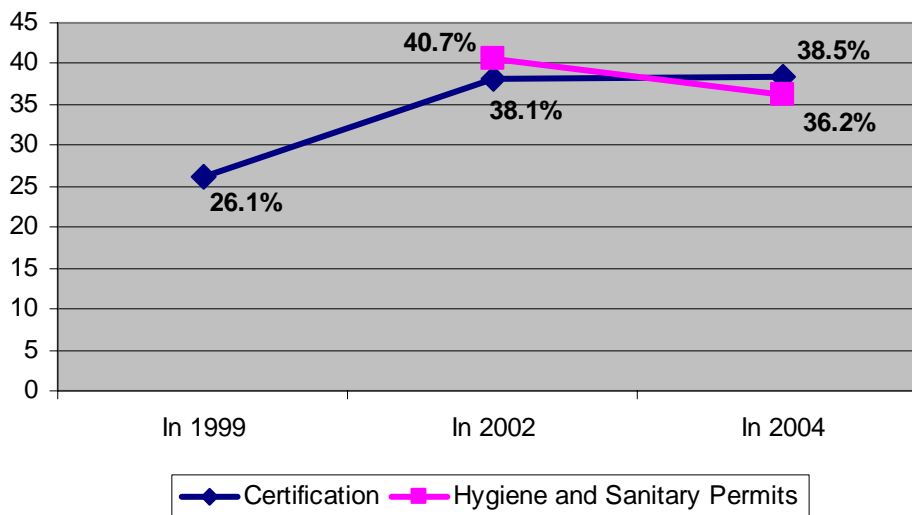


## 2.7. Regulation of Products and Services

Safety of products and services in Ukraine is regulated through the system of conformity assessment (certification) and Hygiene and Sanitary permits. The system of conformity assessment is implemented by third parties under the legal framework of technical regulations. Hygiene and Sanitary permits are implemented directly by state agencies. Regulatory coverage by such certificates and permits is important indicator on the scope of state regulations of products and services.

In 2004 survey, 38.5% of businesses reported that they had to certify their products and services with further 36.2% reported that they had to receive Hygiene and Sanitary permits for their goods and services. This represents almost unchanged regulatory coverage between 2002 and 2004 (see Picture 25).

**Picture 25 Certification and Hygiene and Sanitary permits coverage in between 1999 and 2004<sup>2</sup>**



Similarly, there are no significant changes in the number of respondents that claimed to certify whole production lines (33% in 2004, 30.3% in 2002).

On average, businesses go through certification process for their goods and services 1.7 times per year in 2004. This represents slight decrease from 2.5 times per year reported in 2002. Each time the process takes 11.6 days and costs \$177.8. In terms of time it represents significant increase from 2.3 days reported in 2002 and almost reaches 15.3 days reported in 1999. It is possible that low duration of the certification process in 2002 was temporary and was caused by reform efforts in this sector that lead to certain volatility of procedures and requirements and change in leadership in State Committee on Standardization and Certification. In terms of costs, 2004 data continues significant trend of cost decreases from \$1,212 in 1999 and \$313 in 2002.

<sup>2</sup> In 1999 Hygiene and Sanitary permits were not studied in the CODB survey.

Overall cost distribution by the types of expenses and comparison with 2002 is presented in Table 8.

**Table 8 Payments for certification**

	% Paid		\$ Paid	
	2004	2002	2004	2002
Official fees	-	-	129.3	187.5
Expertise fees	32.5	37.7	97.8	151.6
Notary fees	23.1	15.9	24.2	34.7
Payments to Lawyers	14.4	6.7	56.2	196.1
“Voluntary” contributions	10.5	5.9	57.5	99.6
Unofficial Payments	12.9	12.5	50.7	81.0
<b>Overall</b>			<b>177.8</b>	<b>313.0</b>

Payments to lawyers and “voluntary” contributions show significant increase in coverage over the last 2 years. Instances of unofficial payments remained virtually unchanged.

On average, businesses go through the process of receiving Hygiene and Sanitary permits for their goods and services also 1.7 times per year in 2004. This represents slight decrease from 2 times per year reported in 2002. Each time the process takes 8.8 days and costs \$56.9. In terms of time it represents significant increase from 1.5 days reported in 2002. In terms of costs, 2004 data represents some decrease from \$79.2 reported in 2002.

Overall cost distribution by the types of expenses and comparison with 2002 is presented in Table 9.

**Table 9 Payments for Hygiene and Sanitary permits**

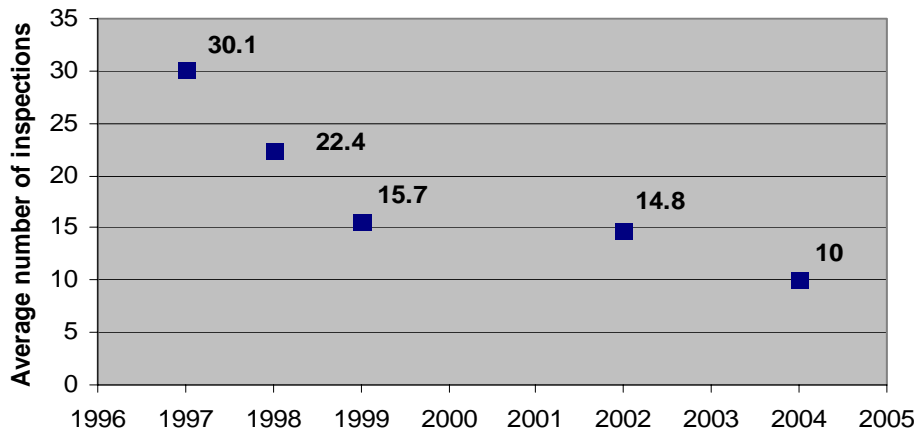
	% Paid		\$ Paid	
	2004	2002	2004	2002
Official fees	74.1	65.5	46.4	65.5
Expertise fees	26.7	32.8	44.5	65.2
Notary fees	15.4	9.7	11.8	29.6
Payments to Lawyers	6.8	4.6	67.9	105.8
“Voluntary” contributions	8.0	8.1	30.1	55.1
Unofficial Payments	13.8	17.8	22.3	42.1
<b>Overall</b>			<b>56.9</b>	<b>79.2</b>

Instances of unofficial payments slightly decreased, while “voluntary” contributions coverage remained the same.

## 2.8. Inspections

Through inspections government agencies enforce laws and regulations. Inspection coverage (% of companies that reported at least one inspection per year), their frequency, duration and expenses businesses pay as punitive or facilitating measures are among most important indicators of the quality of business environment in any country. Inspection frequency (number of inspections per year for an average business) is monitored in Ukraine since 1997. In 2004 this number is 10. This represents decrease in frequency from 2002 when on average 14.8 inspections were reported (see Picture 26).

**Picture 26 Dynamics in the number of inspections between 1997 and 2004**



This decrease in the frequency of inspections is not entirely supported by the perception of respondents. Majority of them believe that the number of inspections did not change much of the last years (see Picture 27).

**Picture 27 Perception of the change in the number of inspections in comparison to year ago (in % of respondents)**

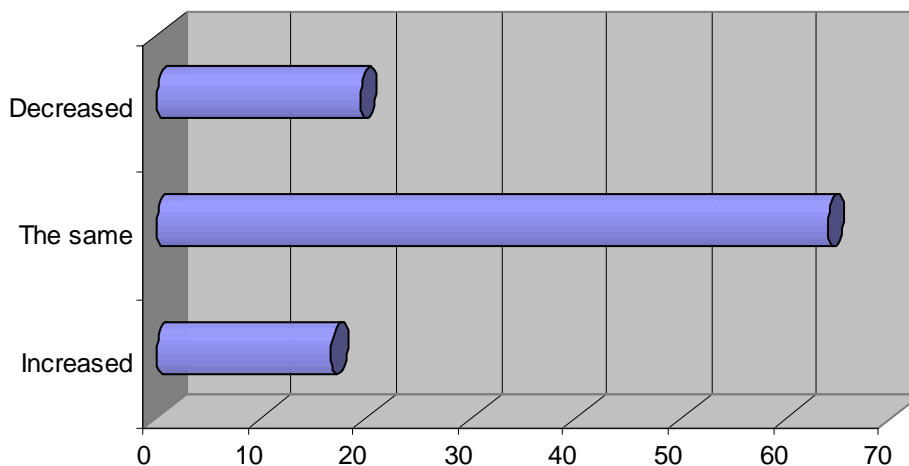


Table 10 illustrates that overall decrease in frequency of inspections was mostly due to decrease in number of inspections per company by Tax Administration, fire department, sanitary inspection, and Militia. Longest inspections in 2004 were carried by KRU, however, due to their insignificant coverage this does not significantly influence overall business environment. Sanitary inspection was most frequent in 2004 and fire department had the highest inspection coverage. Overall inspection coverage shows almost complete stability between 2002 and 2004. Finally, presented in Table 1 agencies, account for great majority of all inspections in Ukraine. In addition to these agencies, in entry “other” respondents were able to name not included agencies that inspected them during last year. There are 14 such additional agencies ranging from Procurator office to Energy Monitoring Committee.

**Table 10 Inspections coverage, frequency, and duration between 1999 and 2004**

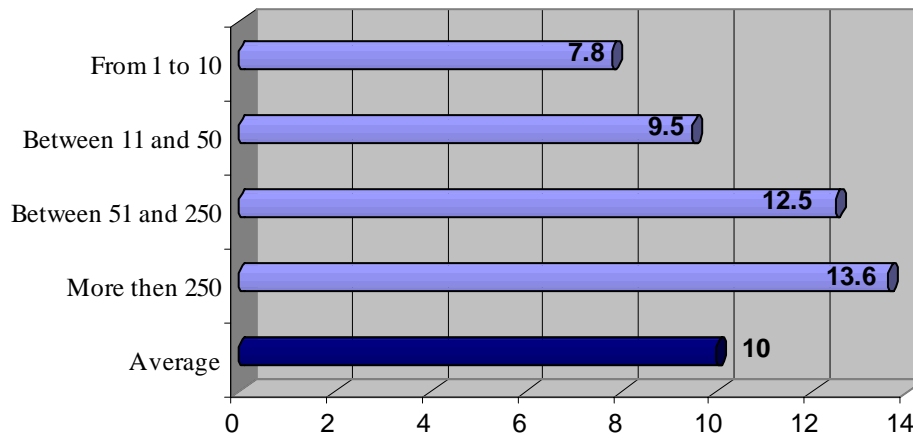
	Coverage, %		Number of inspections			Average duration, days		
	2004	2002	2004	2002	1999	2004	2002	1999
Tax Administration	77.8	79.7	2.5	4.4	5.1	3.4	11.8	13.1
Fire Department	78.7	78.2	2.7	3.5	2.9	2.0	2.7	2.7
Sanitary Inspection	63.3	61.1	3.2	4.9	4.2	1.9	3.3	3.5
Pension Fund	51.1	56.4	1.3	1.4	1.4	1.9	2.1	2.1
Labor protection	42.3	11.3	1.5	1.9	1.2	1.8	2.7	3.0
Militia	23.6	25.0	2.5	6.5	2.0	1.9	4.5	6.1
Environment protection	25.7	30.0	1.7	2.3	0.7	1.7	2.4	2.2
Consumer protection	34.9	35.3	2.0	3.8	1.4	1.6	2.4	2.1
Standard and Certification	27.4	4.4	1.6	1.9	0.9	2.0	3.4	3.1
Antimonopoly Committee	12.3	26.9	1.4	1.4	0.3	1.7	2.9	2.2
Architecture agencies	12.8	9.4	1.6	1.6	0.4	1.3	1.5	1.6
Licensing agencies	16.6	15.3	1.6	1.6	0.6	1.7	1.9	2.4
KRU	20.2	21.3	1.4	1.6	N/A	3.6	8.3	N/A
Other	19.9	19.4	1.7	2.5	1.2	2.1	4.9	8.0
<b>Overall</b>			<b>10.0</b>	<b>14.8</b>	<b>15.7</b>			

Both in 2002 and in 2004 inspection coverage approached 100%. Almost all businesses were inspected at least once. Inspection frequency therefore remains the key indicator especially for comparative purposes.

Picture 28 presents variation of inspection frequencies by business size (number of employees). It was expected that larger businesses will be more frequently inspected. What is surprising is jump in the number of inspections between companies that employ up to 50 employees and companies that employ more than 50. Such jump can be only partially explained by the simplified taxation systems that exist in Ukraine. Actually taking into account such systems, larger jump had to occur when companies employ more than 10 people. Picture 3 probably illustrates other phenomenon, which is called growth glass ceiling, when officials mostly target companies that reach certain level of development. This hypothesis found partial corroboration during Focus Group meetings

when participants claimed that for Ukrainian companies such glass ceiling is \$200,000 - \$500,000 annual turnover.

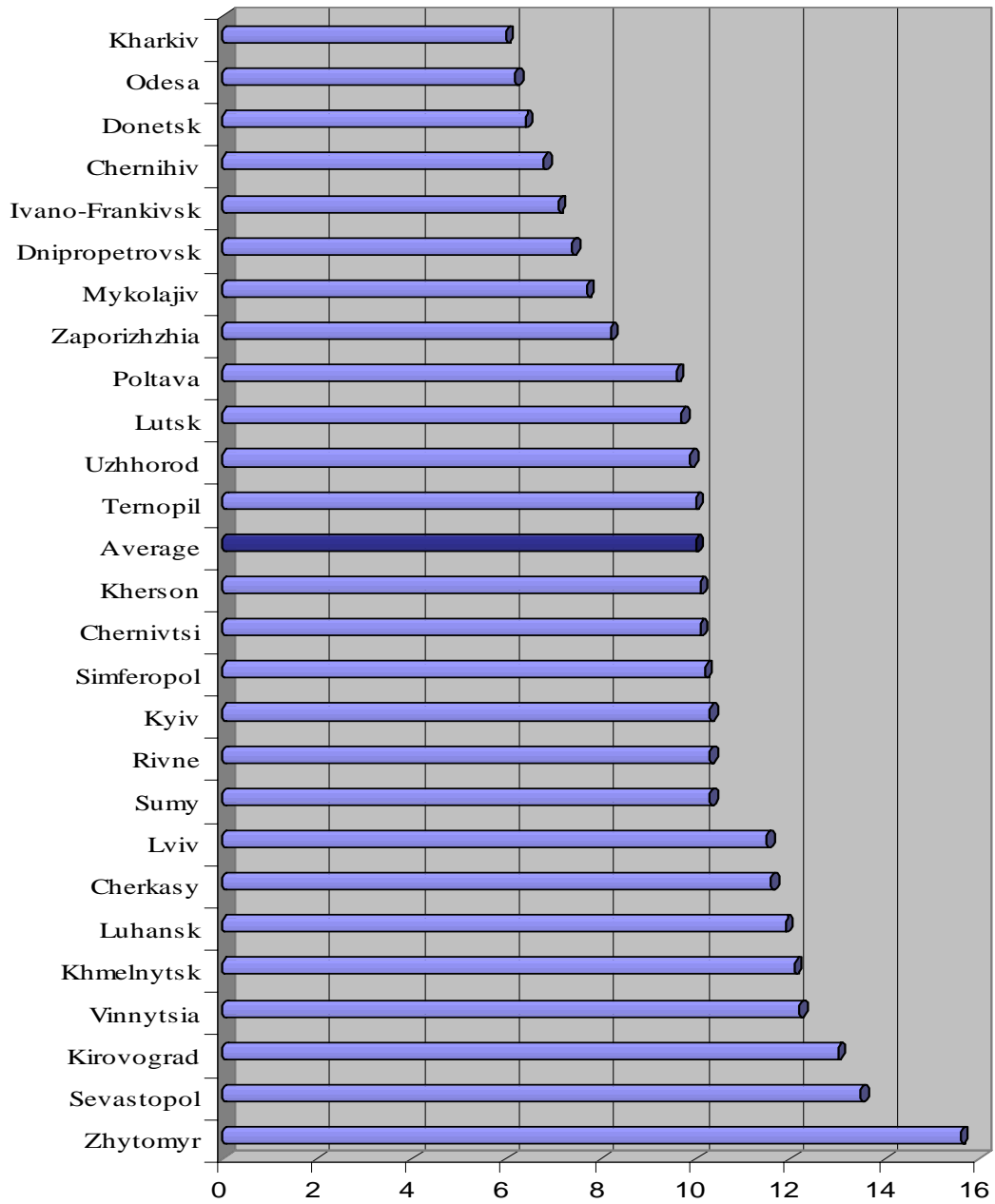
**Picture 28 Inspection frequency by companies' size**



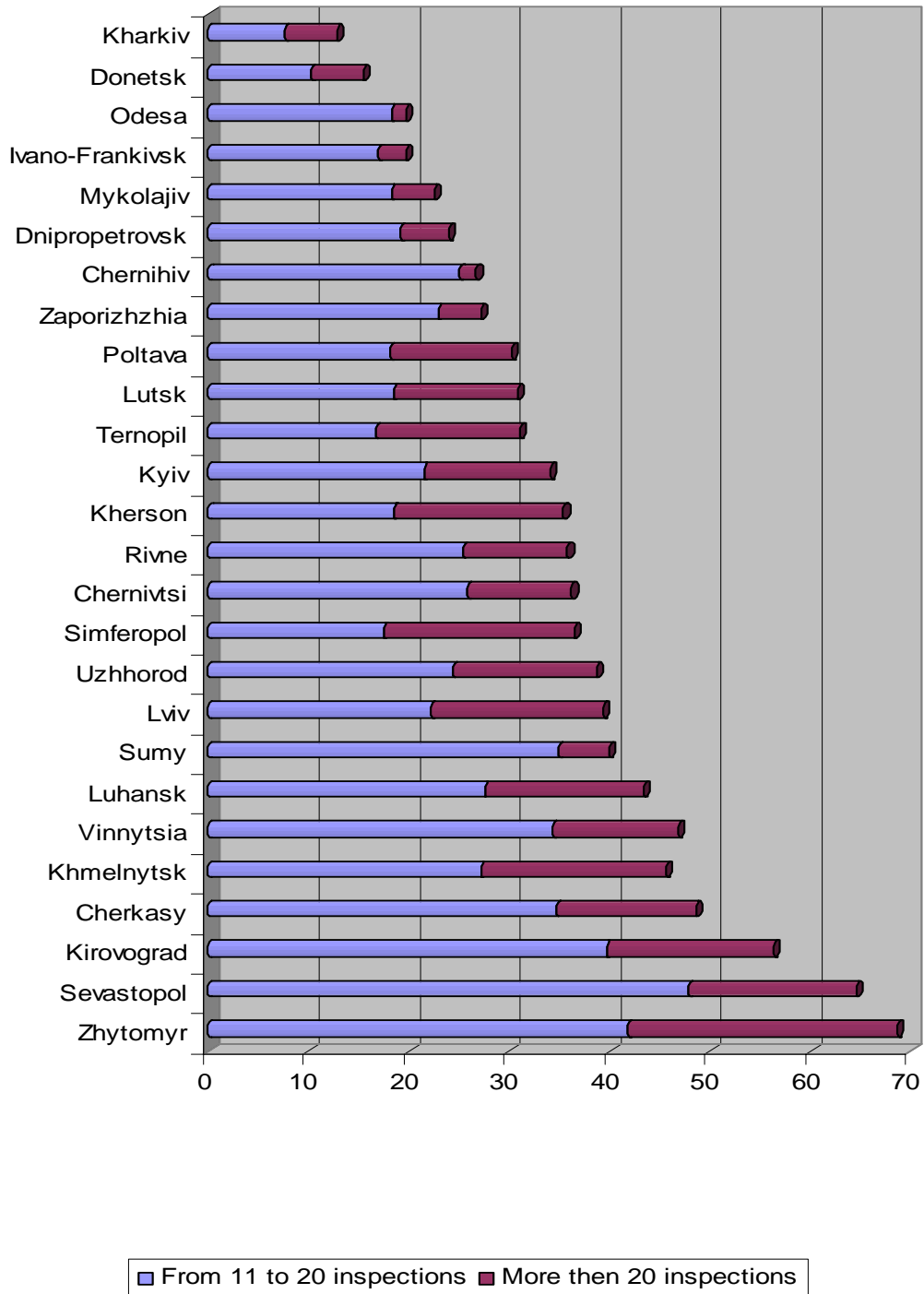
Picture 29 and 30 illustrate another comparison – regional. Because most common inspecting agencies are highly centralized agencies, regional distribution in inspection frequencies are not as varied as regional distribution in other indicators. Even in such insignificant variability the difference in inspection frequency between Kharkiv and Odesa on one hand and Zhytomyr, Sevastopol, and Kirovohrad on another is almost two times (see Picture 29).

Picture 30 represents concentration of companies by region that were inspected more than 10 times during the year. This picture also shows sub-category of companies that were inspected more than 20 times. Such high frequencies can illustrate two different phenomena: either companies in these regions truly violate more regulations and therefore require higher attention through repeated inspections, or this is illustration of selective law enforcement for either economic or political reason. If the second explanation is correct, it might mean that in the regions with low repeated inspections such as Kharkiv and Donetsk, either state officials are aware of negative consequences of selective law enforcement and do not practice it or they succeeded in state capture (high degree of merging between political and business interests).

**Picture 29 Average Inspection frequencies by region**



**Picture 30 Regional variation of cases of frequent (more than 10) inspections, in % of respondents**



In 2004 Ukrainian businesses paid on average \$123.2 in overall inspection costs. Most of these expenses were related to fines and unofficial payments. There were also some, although not numerous cases, of confiscations of goods. These were mostly reported regarding Tax Administration (1.4% of inspections ended with confiscations), KRU (1.1%), and Sanitary inspections (0.8%). In 2002 average Ukrainian companies paid \$1,177.8 in inspection costs. Very significant decrease over the last two years is almost fully related to the decrease in fines collected by Tax Administration, as reported by respondents (see Table 11)

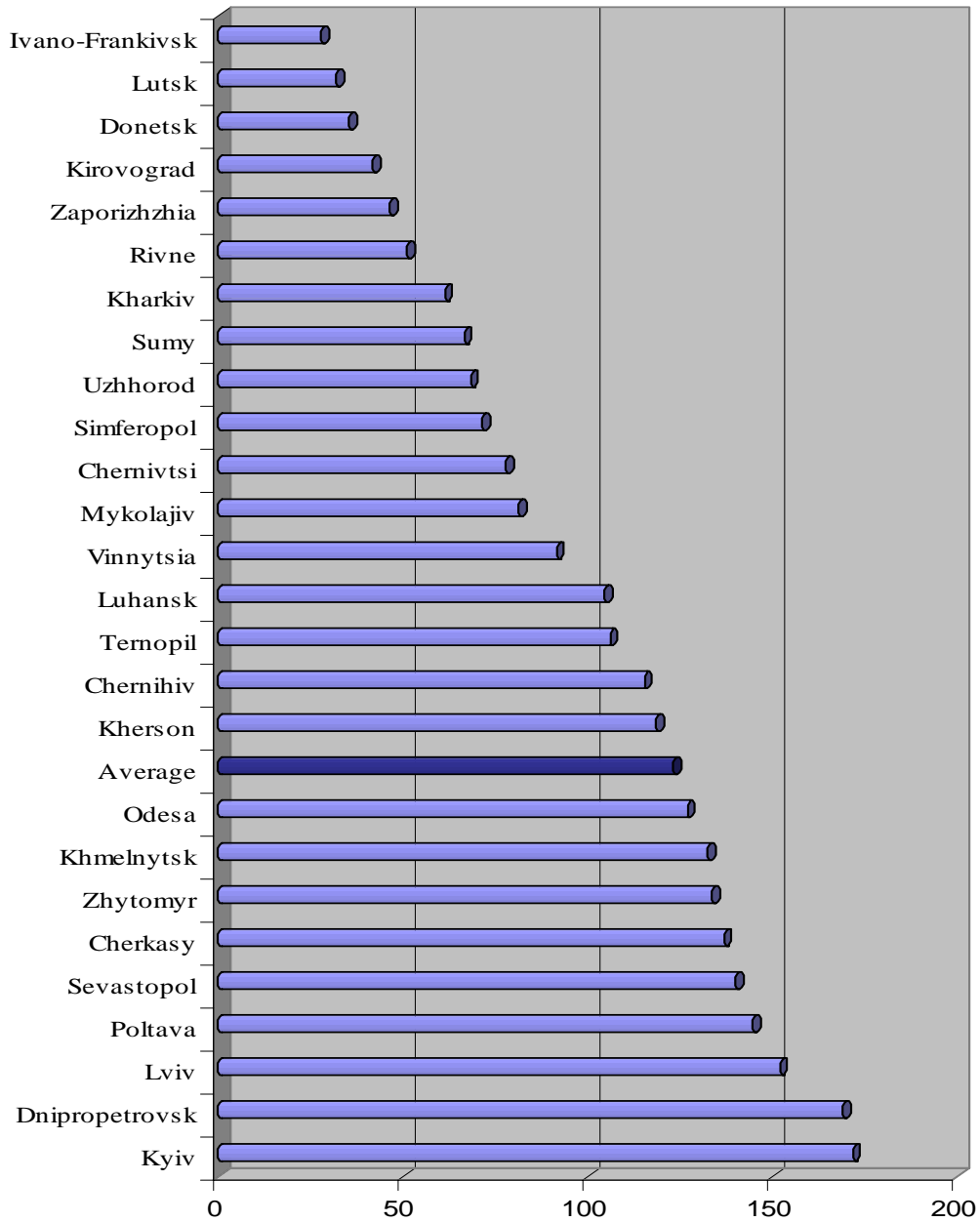
**Table 11 Inspections costs by agencies in 2002 and 2004**

	Fines paid, %		Fines, \$		Unofficial payments, %		Unofficial payments, \$	
	2004	2002	2004	2002	2004	2002	2004	2002
Tax Administration	46.7	40.2	238.5	2,910	13.6	9.9	95.6	218
Fire Department	27.4	15.7	29.2	76.7	12.3	10.9	48.1	95.5
Sanitary Inspection	26.0	11.5	39.2	48.0	9.7	6.8	63.9	95.4
Militia	6.8	1.8	34.7	82.6	8.0	3.6	65.4	84.6
Environment protection	18.7	4.4	59.9	493.2	1.9	1.0	-	64.7
Consumer protection	17.7	5.8	84.5	85.4	4.3	1.5	89.9	-
Standard and Certification	5.5	2.2	23.8	100.2	1.2	0.7	28.3	-
Antimonopoly Committee	1.4	0.9	127.3	470.2	0.5	0.1	-	-
Architecture agencies	7.4	0.9	42.5	62.3	3.1	0.6	48.7	69.4
Licensing agencies	5.4	0.6	157.4	86.0	2.7	0.2	-	-
Labor protection	11.6	4.6	39.4	78.5	1.8	1.1	19.8	93.4
Pension Fund	6.2	4.8	36.0	35.8	1.3	0.8	25.7	-
KRU	11.8	1.7	107.5	239.4	4.1	0.8	-	-
Other	21.7	2.9	43.9	52.8	3.8	1.0	34.7	47.2

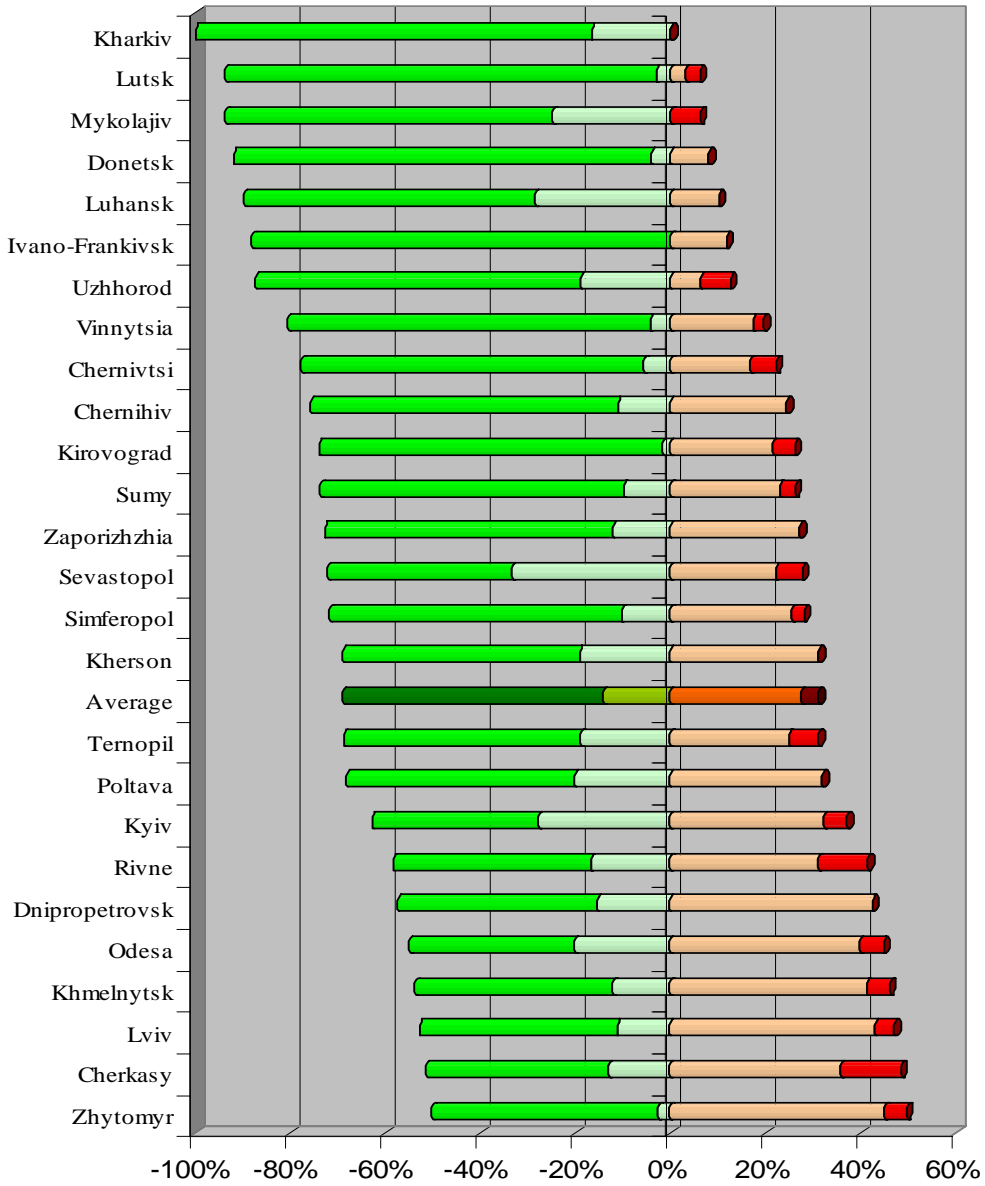
On the other hand, almost in all cases more inspections culminated in fines in 2004 than in 2002. Especially this is the case with Fire department, sanitary inspections, environment protection, and consumer protection agencies. Instances of unofficial payments also significantly increased.

Inspection costs variation by regions is presented on Pictures 31 and 32. Picture 31 represents average inspection costs per region. Lutsk and Ivano-Frankivsk remain cheapest in inspection costs since 2002. While Lviv, Cherkasy, and Zhytomyr, remain among most expensive since 2002. Due to overboard cost decrease, there are no cities in which inspection costs actually increased in 2004. Picture 32, in turn represents cost distribution by region. Here Kharkiv is the city where all costs are quite small (up to UAH 1,000 (\$188.7)). At the same time, quite large share of businesses in Lviv, Cherkasy and Zhytomyr pay much higher costs. Rivne and Cherkasy has greatest share of businesses that pay over UAH 5,000 (\$943.4).

**Picture 31 Average inspection costs by region**

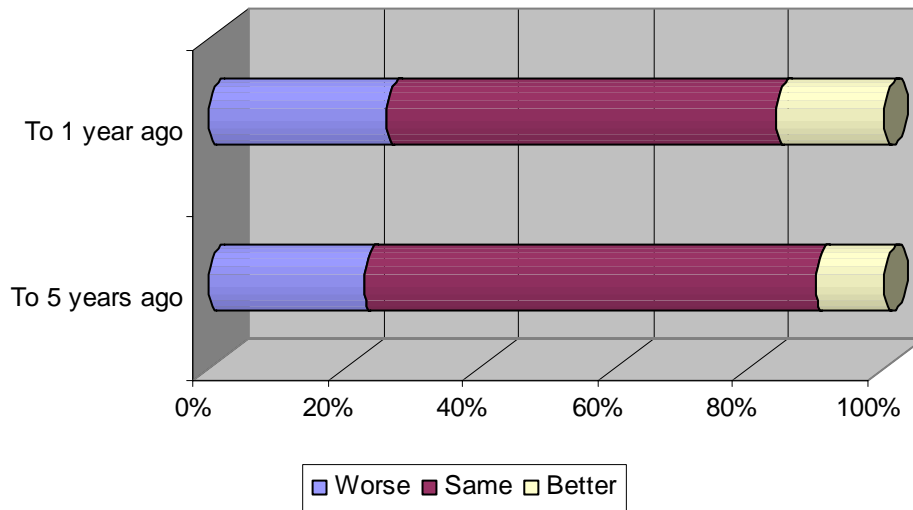


**Picture 32 Costs distribution by region**



Finally, overboard inspection costs decrease surprisingly is not reflected in perception of respondents. If asked if situation with inspections deteriorated or improved in comparison to one and five years ago, most respondents declared that it did not change. Moreover, share of those who believe situation deteriorated is somewhat larger than those that believe it improved (see Picture 33)

**Picture 33 Perception of dynamics of situation with inspections**



The reason for this can be explained by Table 11 data on greater coverage of fines and higher instances of unofficial payments. In other words, decrease in frequency and costs associated with inspections was probably offset by higher probability for paying fines and unofficial payments from the point of view of respondents.

## 2.9. Regulation of Prices

Generally, as in 2002, among regulations that hinder business development in Ukraine, regulation of prices is not considered to be a major obstacle. In 2004, 28% of businesses experienced regulation of prices according to the survey. This is virtually the same as 27.6% reported in 2002 and is not very different than 30.2% reported in 1999. Like in 2002, most businesses that claim that their prices are regulated, reported that their goods and services are subjects of fixed prices or price ceilings (see Table 12).

**Table 12 Regulation of prices between 1999 and 2004 in % of respondents**

	2004	2002	1999
Prices are free	72%	72.4%	69.8%
Restrictions on profitability	6.5%	6.0%	7.3%
Fixed prices	11.5%	8.7%	10.1%
Price ceiling	11.7%	8.3%	11.9%
Minimal price	6.7%	4.7%	N/A

Share of involvement of specific agencies in price regulation in 2004 also remained virtually unchanged from 2002. Only State Administrations (both Oblast and Rayon level) somewhat increased their share of price regulation in comparison to other agencies, while State Tax administration decreased its share. State Price Committee remains most frequent price regulator in Ukraine (see Table 13).

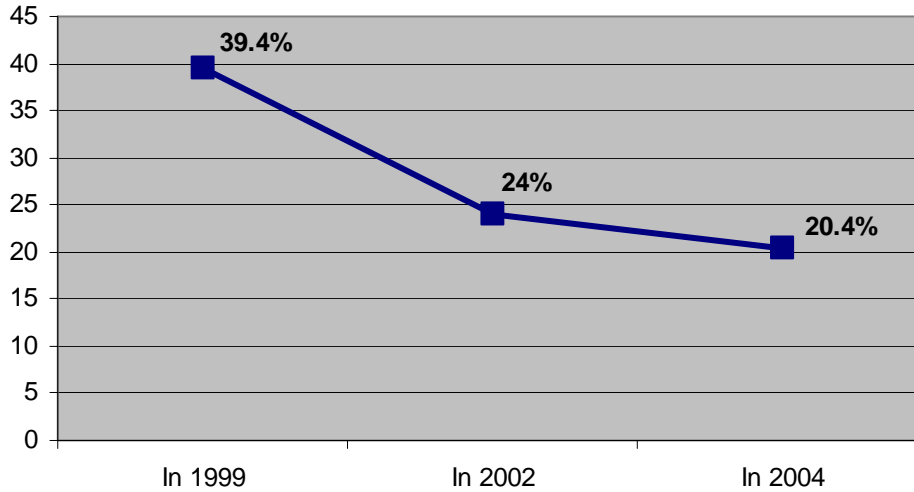
**Table 13 Regulation of prices between 1999 and 2004 by agencies in % of respondents**

	2004	2002	1999
Antimonopoly Committee	9.4%	9.3%	15.2%
Branch Ministries	9.3%	10.2%	10.3%
Local State Administration	17.9%	14.0%	31.5%
Local self-government	6.5%	7.8%	14.1%
Tax Administration	17.8%	20.2%	19.0%
State Price Committee	23.2%	23.5%	41.8%
Other	17.2%	25.2%	16.8%

## 2.10. Regulation of Contracts

In 2004, 20.4% of respondents claimed that their contracts were monitored by state agencies. This is lower than 24% reported in 2002 (see Picture 34)

**Picture 34 Monitoring of contracts by government agencies between 1999 and 2004 in % of respondents**



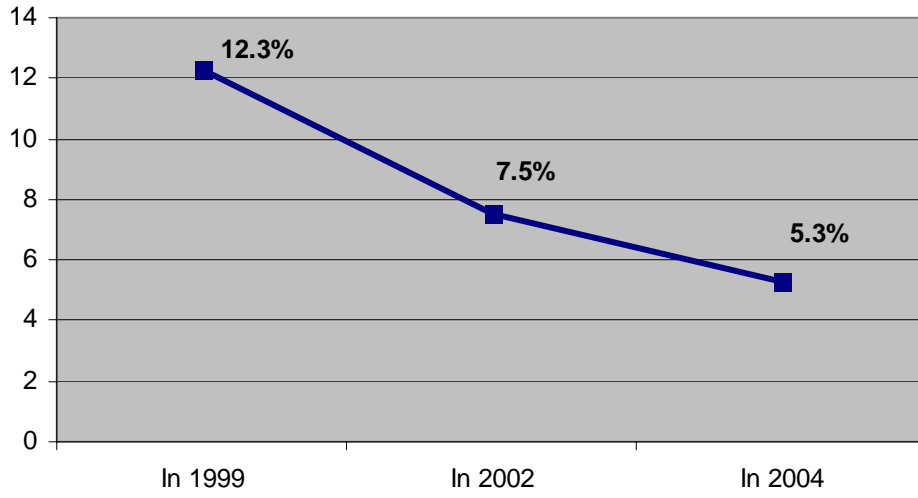
Comparison of the aspects of contracts that are monitored or regulated between 1999 and 2004 are presented in Table 14.

**Table 14 Regulation of prices between 1999 and 2004 by agencies in % of respondents**

	2004	2002	1999
Prices	54.1%	47.6%	47.7%
Types of goods	37.3%	27.1%	38.4%
Contract size	36.1%	32.6%	36.3%
Settlement terms	47.3%	59.6%	66.7%
Partners	30.5%	34.2%	35.3%

In 2004, 5.3% of respondents claimed that they were unable to fully complete contracts due to interference from state agencies. This also represents decrease from 7.5% reported in 2002 (see Picture 35).

**Picture 35 Respondents that were unable to fulfill contracts due to state interference**



## **3. Administration of Taxes**

### **3.1. Research Design and Methodology**

The following component of the research was conducted by used methodology comprised from three distinctive approaches such as quantitative survey, structured Focus Groups, and in-depth qualitative interviews. All these approaches provided data for comprehensive analysis of tax regime in Ukraine.

Quantitative survey provided wealth of statistical data that allowed for benchmarking and correlations. Quantitative interviews allowed advanced causal analysis, while Focus Groups were essential in assessment of perceptions and attitudes of businesses.

The research was conducted using separate samples for exporting and importing companies. All stages of the research were conducted in May-June 2004.

The quantitative survey part was conducted on nationally representative sample of 300 companies in 6 regions of Ukraine, namely Lviv, Khmelnyck, Kharkiv, Ivano-Frankivsk, Odesa, Kherson.

All data was collected during face to face interviews conducted by trained interviewers according to designed and piloted questionnaire. All interviews were conducted with management of responding companies (director or deputies in charge of export operations). CID ensured 10% external quality control. Statistical analysis was done using SPSS program.

Four Focus Groups were conducted in different localities in Ukraine in May of 2004. These included Kherson, Kharkiv, Lviv, and Transcarpathian region. All FG were conducted with 10-15 managers or owners of businesses using designed template. Template entries were read and after short discussion data was entered only if consensus was established during each FG on each template entry. Mean data from four FG is presented in the report below.

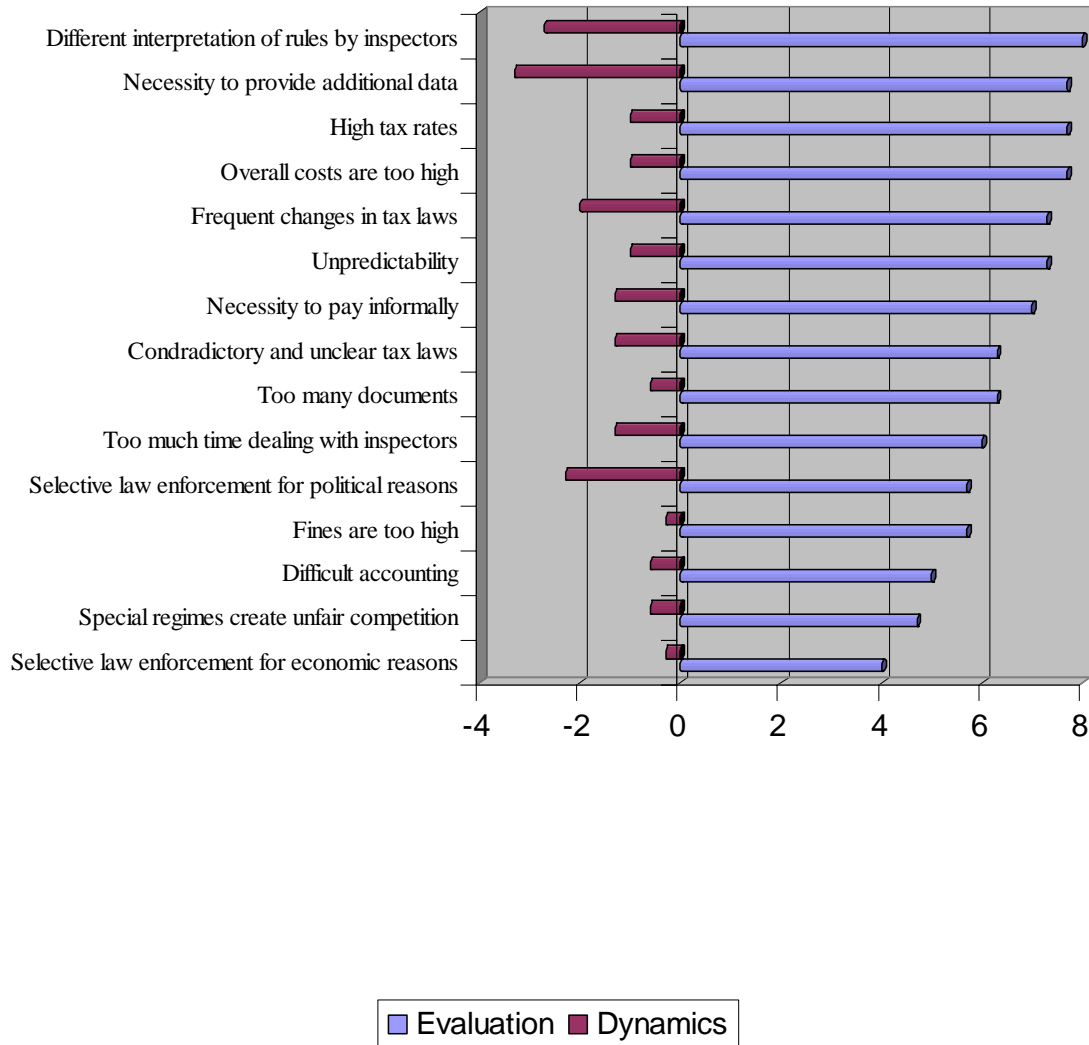
There were 30 in-depth interviews with managers or owners conducted in the same regions as FG. All in-depth interviews were conducted by trained experts in face to face manner with directors of large enterprises. These interviews were also conducted according to the designed template.

### **3.2. Tax Regime**

#### **3.2.1. General Evaluation**

Picture 36 presents data derived from Focus Groups discussion on general evaluation of the Ukrainian Tax regime, as well as perception of dynamics during last year.

**Picture 36 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year).**

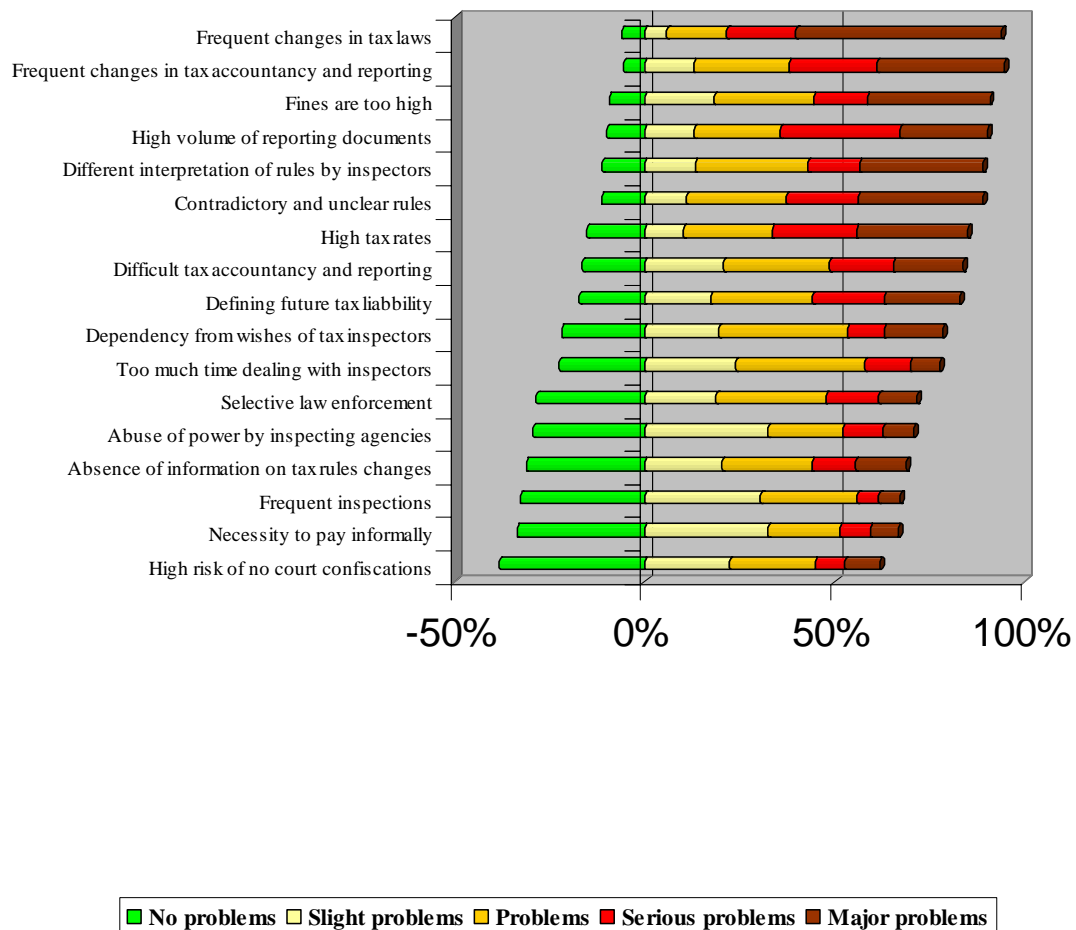


Focus groups and qualitative interviews provide some insights into evaluation of these statements. It is interesting to note that general unpredictability which is caused by changing interpretation of laws by inspectors, necessity to provide additional data, frequent changes in tax laws scored somewhat more negatively than actual expenses and tax rates. FG participants and qualitative interviews respondents pointed specifically to the practice of explanatory letters by State Tax Administration (STA) which establish certain practices which are sometimes inconsistent with laws. One of the greatest problems is that these letters are quite frequent and not necessarily open to general

public. This allows individual tax inspectors to interpret rules differently. Frequent changes in requirements were also mentioned in relation to other issues that were evaluated, most specifically with accounting and number of documents.

FG data is strikingly similar to the data obtained by quantitative survey (see Picture 37). Again, stability of the tax regime receives most negative evaluations. This is followed by arbitrary interpretation and high sanctions.

**Picture 37 Evaluation of problem areas by survey respondents (% of respondents)**



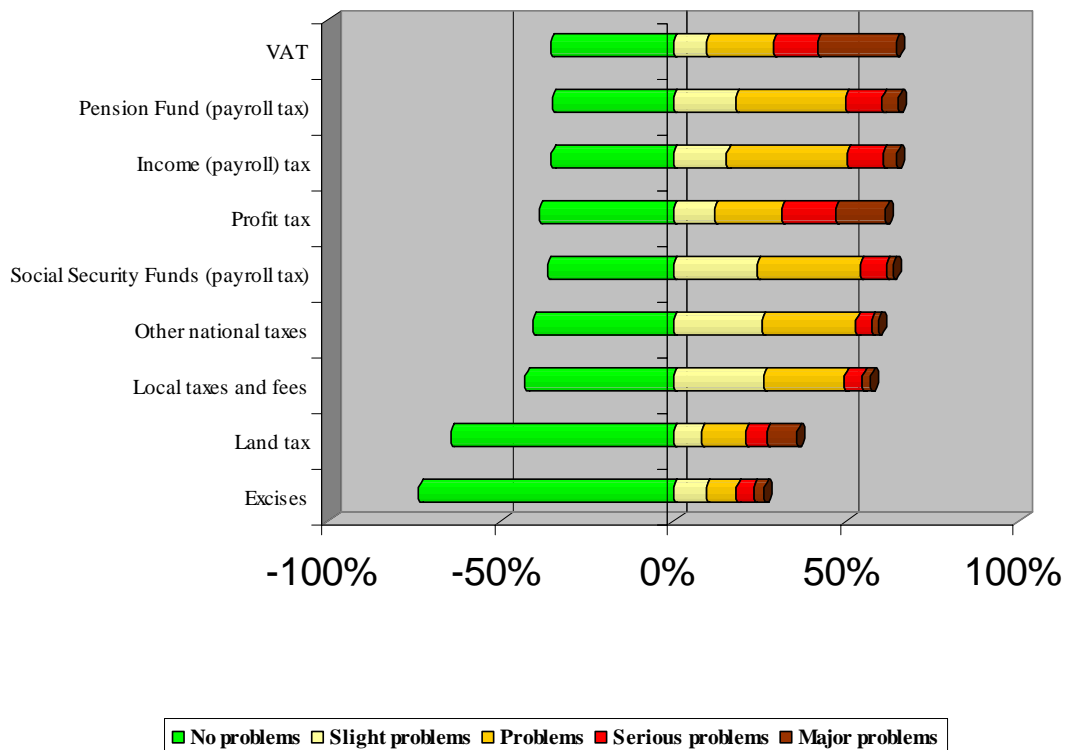
On the other hand, issues that were considered very problematic few years ago, such as frequent inspections, extra-judicial confiscations (kartoteka 2) and even informal payments received comparatively more positive evaluations. There are two conflicting

conclusions that can be made based on this data. The first is that if something is considered highly problematic, it is eventually addressed and resolved. The second relates to adjustments that businesses made over time. In other words, mature business community can adjust to difficult environment easier than to fluid environment. Main problem of Ukrainian tax system is that it is highly unstable and unpredictable. Therefore even some positive changes such as decrease of frequency of inspections, extra-judicial confiscations, some decrease in rates of taxation do not have impact that would be possible if the whole system would be more predictable.

There is one additional observation that can be made. Selective law enforcement for political reasons became measured in Ukraine in 2002 by the World Bank. Overall, and comparatively to other issues, this indicator received average evaluation. On the other hand, only 28.3% of respondents stating that it is not a problem. Similar share of respondents, 24.1% stated that it is serious or major problem.

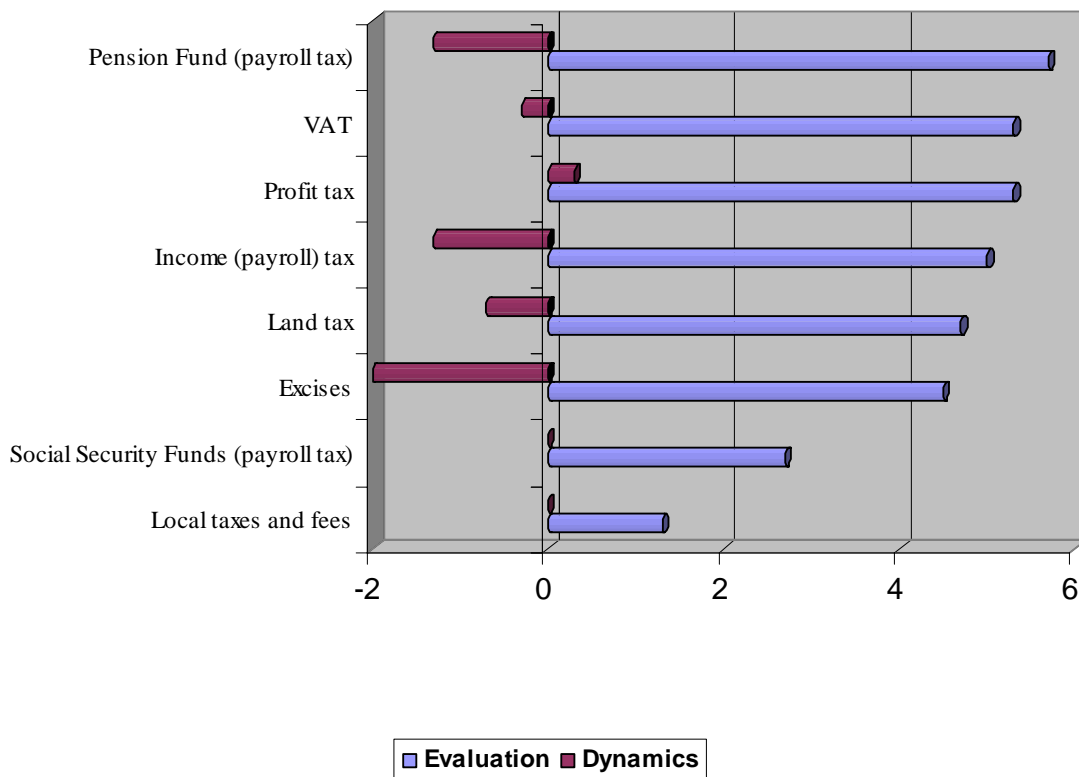
If asked to evaluate administration of specific taxes, survey respondents single out VAT as the most problematic tax (see Picture 38). This tax is followed by payroll taxes profit tax.

**Picture 38 Evaluation of specific taxes by survey respondents (% of respondents)**



Similar question was asked during the Focus Group discussions. VAT and Pension Fund payments also received most negative evaluation (see Picture 39). Profit tax was the only tax that received positive evaluation on dynamics (FG participants believe that situation during the last year improved). Explanation for this is some decrease in the profit tax rated during last year.

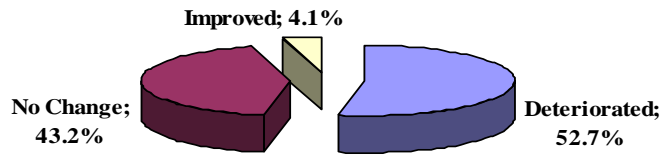
**Picture 39 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year).**



Both FG and qualitative interviews were conducted during the time of implementation of later eliminated special VAT accounts. Perception of these accounts was extremely negative by almost all research participants. Problems with Profit tax relate mostly to the difficulties in defining and calculating deductions. Pension Fund payments are considered prohibitively high and a main reason for informal payments of the part of salaries. Social Security Funds payments on the other hand are problematic due to the number of accountancy forms and time spent in administration of them.

Finally, survey respondents believe that during the last year administration of tax collection in Ukraine deteriorated (see Picture 40).

**Picture 40 Evaluation of annual change in tax administration in % of respondents**

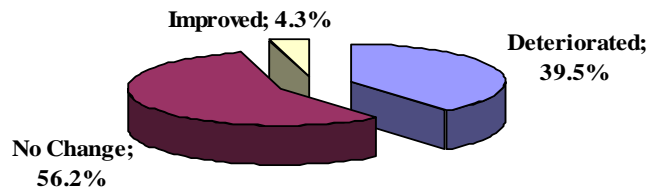


### **3.2.2. Number of Taxes and Reporting Forms**

In the quantitative survey, the high volume of reporting forms received more negative evaluation than high tax rates. On average, Ukrainian company pays 9.14 various taxes and fees. Most common are: income tax for physical persons; Pension Fund payment; various social security funds payments (all are parts of the payroll taxes with independent accounting, reporting and audit); VAT; Profit tax; Communal tax; and land tax.

In order to fulfill all tax obligations, average Ukrainian company must submit 53.4 originals and 42.7 copies of different tax declarations per year. Unlike general tax administration, volume of reporting document from the point of view of the survey respondents remained largely unchanged during the last year (see Picture 41)

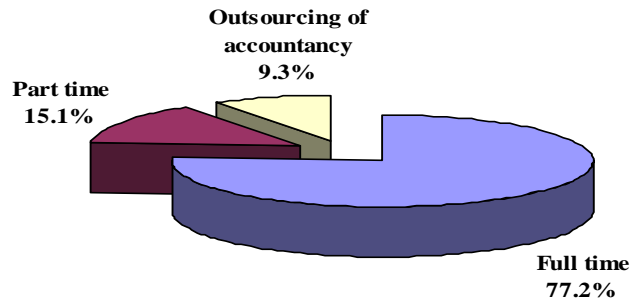
**Picture 41 Evaluation of annual change in volume of reporting documents in % of respondents**



Data from qualitative interviews suggested that most reporting companies must do to fulfill their obligations as VAT payees. Indeed, 73.2% survey respondents, who pay VAT, submit on average 33.1 originals of tax returns for VAT per year.

In order to fulfill all tax obligations and submit reporting in timely manner, Ukrainian businesses employ accountants who mostly work on tax accountancy. 77.2% of surveyed companies employ full time accountants (see Picture 42)<sup>3</sup>. On average, there are 2.2 full-time accountants per enterprise.

**Picture 42 Employed tax accountants in % of respondents**



Further 15.1% of respondents employ part time accountants with average of 1.3 employed by average company. And only 9.3% of surveyed companies were able to outsource accounting services to outside firms of individual accountants.

Using these data one can calculate how much it costs businesses in direct labor to fulfill tax obligations in Ukraine. Assuming average compensation for full-time accountant is approximately \$200 per month and part-time accountants is \$100 per month, with further \$100 paid on average for outsourced accountancy, it is possible to calculate that average Ukrainian company spends \$4,407.6 per year in direct labor costs to fulfill tax obligations.<sup>4</sup>

### **3.2.3. Special Tax Regimes**

Many in Ukraine point to existence of special tax regimes for either whole territories (Free Economic Zones), industries of specific companies as the main reason for high tax rates for all other businesses as major means for compensation of tax revenue.<sup>5</sup> International financial institutions voice strong opposition for such practices. The scope of usage of special tax regimes and business perceptions about them were addressed in the quantitative survey. According to this survey, 15.8% of companies benefit from such

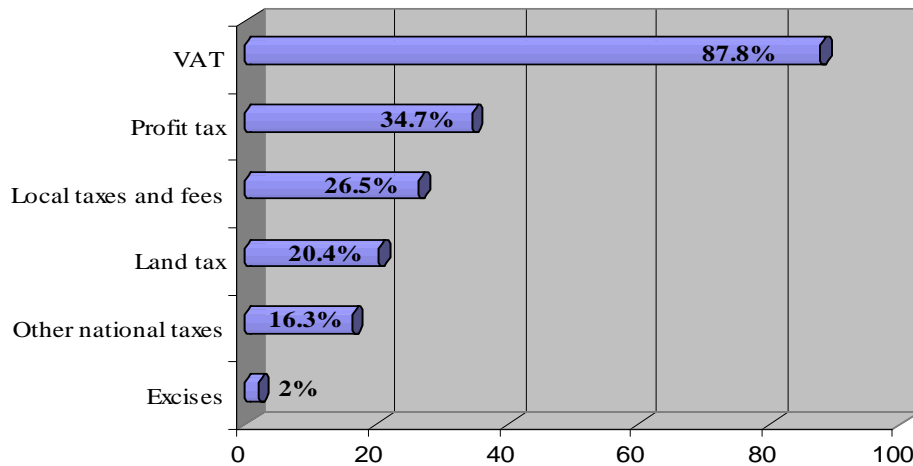
<sup>3</sup> Total percentage is greater than 100% because some respondents have both full-time and part-time accountants.

<sup>4</sup> Average compensations for accountants are not based on statistical data, they are assumed based on job advertisements published in Ukraine for positions of tax accountants.

<sup>5</sup> Special tax regimes relate to what is defined as *Pilhy* in Ukrainian. These do not include simplified taxation systems for SMEs.

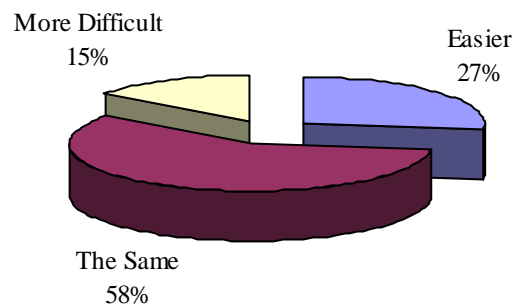
special regimes that might include no taxing of certain types of profits, goods or operations, usage of “0” rate of taxation, etc. Effectuated taxes most frequently include VAT and Profit tax (see Picture 43).

**Picture 43 Usage of special tax regimes by effected taxes in % of respondents**



If asked if special tax regimes actually simplify tax administration, respondents provided unexpected answers (see Picture 44)

**Picture 44 Comparison of special tax regimes to average regime in % of respondents**

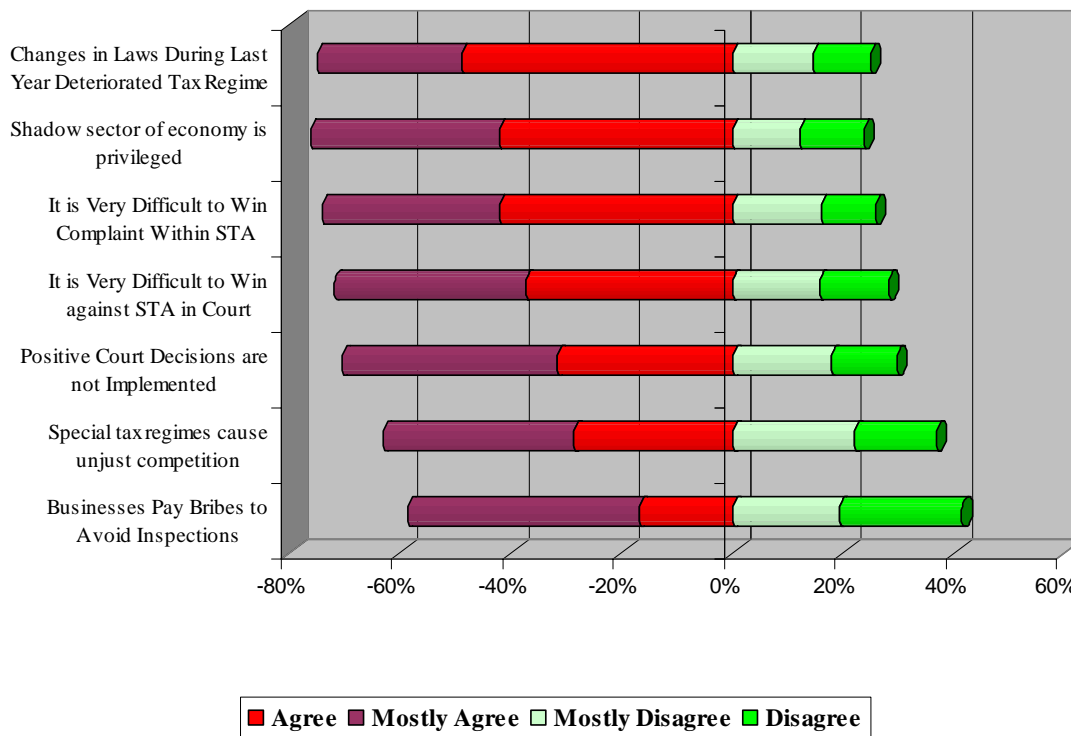


Only 27% of respondents claimed that tax administration in special regimes is easier, while 58% believe it is the same. This means that special tax regimes are selected and lobbied mostly for lower tax rates.

### 3.2.4. Evaluation of Causes for Negative Elements of Tax Regime

Picture 45 presents evaluation by survey respondents of the statements that can characterize causes for negative characteristics of tax regime in Ukraine.

**Picture 45 Evaluation of the statements that can characterize causes for negative characteristics of tax regime (% of respondents)**

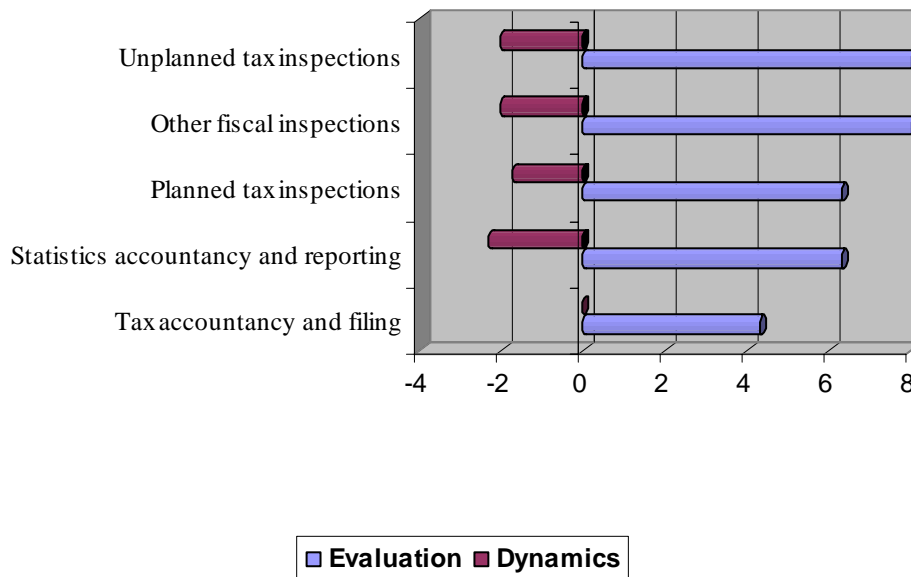


Survey respondents are consistent in evaluating instability of taxation legal framework as major cause for negative tax regime. Moreover, they believe that legal changes themselves deteriorate this regime. They also believe that Ukrainian tax regime creates conditions for shadow economy growth from which they eventually face unfair competition. These elements are closely followed by strong believe in impossibility to fair arbitration and implementation of winning cases.

As for administration and enforcement of tax regime, FG participants and respondents of qualitative interviews were asked to comparatively evaluate various elements of enforcement and administration (see Picture 46). Unplanned tax inspections and other fiscal inspections (mostly by Pension Fund) received most negative evaluations. Businesses believe that in many cases these inspections are not justified, it is not defined or properly communicated why they are initiated. Surprisingly planned inspections also received relatively negative evaluation. The main cause for this is their undefined and

unpredictable duration. Finally there is strong perception of significant increase in statistical reporting during last year.

**Picture 46 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**

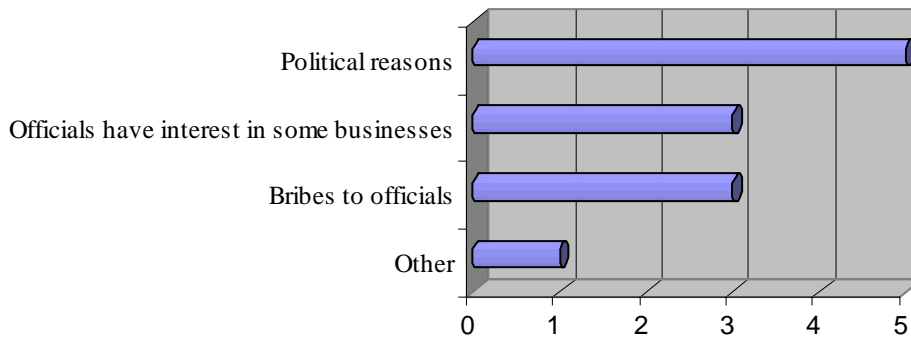


One of the most pronounced causes for negative tax regime in various countries also relate to the uniformity of its enforcement or equality of businesses. This directly correlates with predictability and fairness of tax regime. During qualitative interviews and FGs, respondents were asked to evaluate if tax regime is uniformly implemented and enforced to all businesses in Ukraine. On the 5 – point scale, the average evaluation was “4” meaning that most businesses believe that practice of selective law enforcement in the area of taxes is widespread in Ukraine.

Businesses were asked to evaluate three most probable reasons for this ranging from petty corruption (taking bribes by officials) to classic cases of state capture or grand corruption (cases when officials have interests in specific companies) to total state capture and merging of political and business interests (selective law enforcement for political reasons). For the reason of comparison, businesses were also asked if any other reasons exist for not uniformed implementation of tax regime. Data of such evaluation (5 – point scale) is presented in Picture 47. There are two major findings. The first one is that mentioned reasons are exhaustive. “Other” received minimal rating. The second finding is surprising. Corruption and classical state capture was believed to be major

reasons for not uniformed tax regime in Ukraine. However, political reasons received by far highest rating.

**Picture 47 Evaluation of Causes for not Uniformed Tax regime**



This means that Ukraine currently can be characterized by the elements of total state capture when public and private interests merge and reinforce each other.

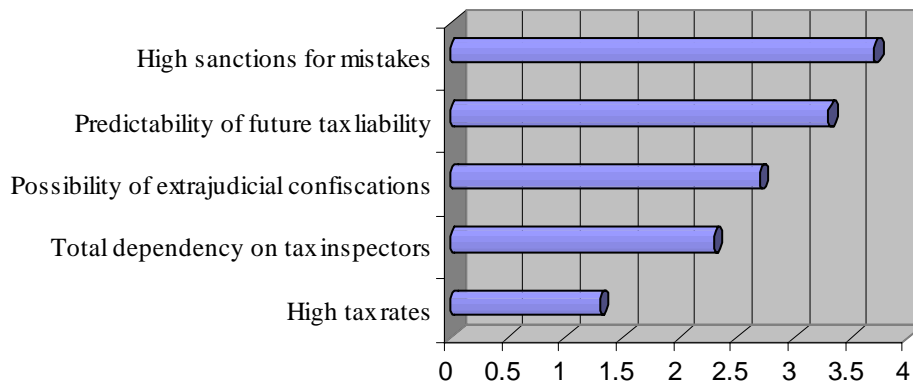
### **3.2.5. Conclusions: Policy Ramifications**

12. Tax regime in Ukraine can be characterized as quite volatile and unpredictable. This is of highest concern for businesses. Volatility depends both, on frequent changes in Laws and on inconsistencies in implementation. Practice of frequent STA explanation letters that reinterpret laws is highly negative. Therefore, moratorium on changing tax laws will not resolve this problem. Such moratorium will be effective if STA will lose formal or informal power to reinterpret laws.
13. The most problematic tax in Ukraine is VAT due to the problems of its administration and high volume of related accountancy and reporting. This is followed by payroll taxes which are both, prohibitively high (due to Pension Fund payments) and also carry high volume of accountancy and reporting (due to the numerous Social Security Funds). This leads to the necessity of reforming pension system with the purpose of decreasing Pension Fund payments and consolidation of Social Security Funds. Current situation leads to shadow payments of parts of salaries reinforcing need for higher Pension Fund rates.
14. Ukraine currently is characterized by the elements of total state capture when public and private interests merge and reinforce each other. This is the major cause for not uniformed tax regime and selective law enforcement. This directly correlates with predictability and fairness of tax regime as well as with

willingness by businesses to comply with tax obligations. If not resolved, this phenomenon might negate all other reforms of Ukrainian tax regime.

15. Finally, FG participants and qualitative interviews respondents were asked to prioritize themselves what elements of tax regime must be addressed at the beginning. Their opinion is highly surprising but consistent with other research findings. Tax rates received the lowest priority evaluation from possible reform initiatives (see Picture 48). High penalties for mistakes are believed to be most pressing. As well this issue is one of the easiest to be reformed.

**Picture 48 What elements of tax regime must be addressed at the beginning**



## 4. International trade

### 4.1. Research Design and Methodology

#### 4.1.1. Introduction

The following component of the research was conducted by used methodology comprised from three distinctive approaches such as quantitative survey, structured Focus Groups, and in-depth qualitative interviews. All these approaches provided data for comprehensive analysis of international trade regime.

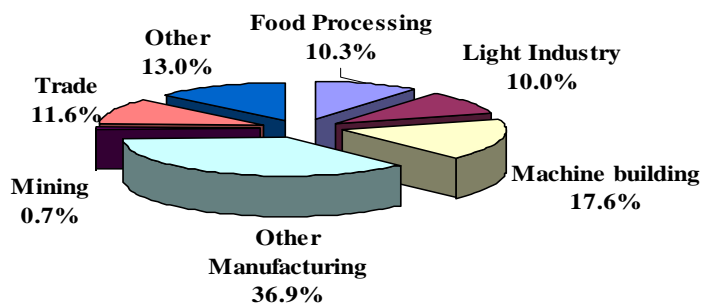
Quantitative survey provided wealth of statistical data that allowed for benchmarking and correlations. Quantitative interviews allowed advanced causal analysis, while Focus Groups were essential in assessment of perceptions and attitudes of businesses.

The research was conducted using separate samples for exporting and importing companies. All stages of the research were conducted in May-June 2004.

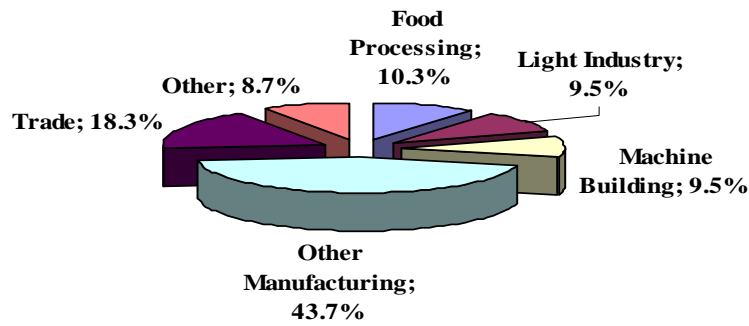
#### 4.1.2. Methodology

The quantitative survey part was conducted on nationally representative sample of 500 exporting companies in 6 regions of Ukraine, namely Lviv, Khmelnyck, Kharkiv, Ivano-Frankivsk, Odesa, Kherson, and 200 importing companies in Lviv, Kharkiv and Odesa. Sectors in which these companies operate are presented in Pictures 49 and 50. While by organizational form the distribution is presented in Pictures 51 and 52.

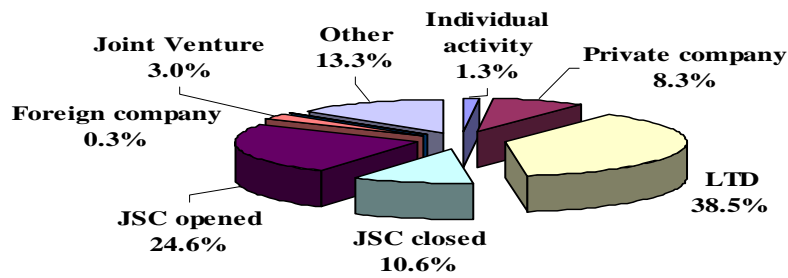
**Picture 49 Sample distribution of exporting companies by sector of economy**



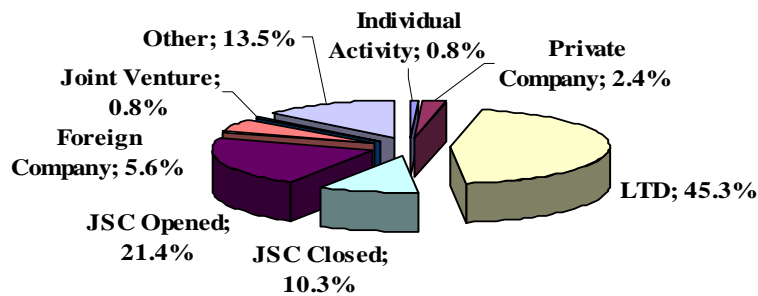
**Picture 50 Sample distribution of importing companies by sector of economy**



**Picture 51 Sample distribution of exporting companies by organizational form**



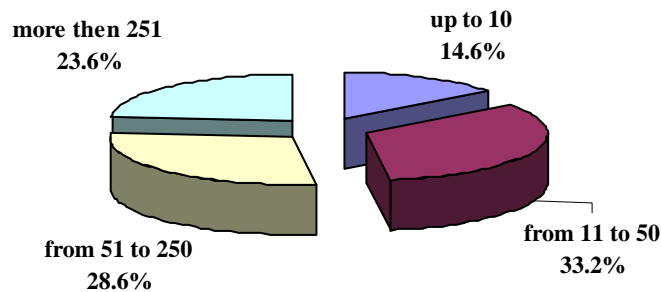
**Picture 52 Sample distribution of importing companies by organizational form**



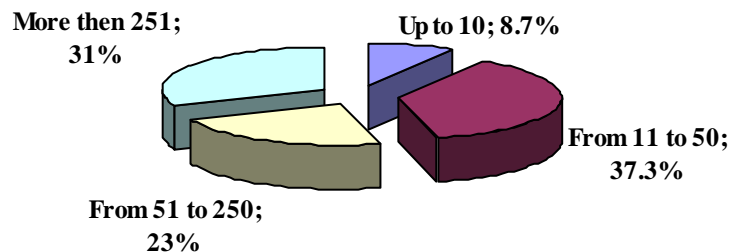
By ownership, for exporters, 5.9% of responding companies are fully state owned, further 9.4% reported various shares of state property. There are also 6.2% fully foreign owned companies with further 13.8% reported various shares of foreign ownership. For importers, 4.8% of responding companies are fully state owned, further 12.4% reported various shares of state property. There are also 7.9% fully foreign owned companies with further 21.1% reported various shares of foreign ownership.

Pictures 53 and 54 illustrate size of surveyed companies by the number of employees. There are more medium and large companies among companies that are engaged in international trade then on average in Ukrainian economy.

**Picture 53 Sample distribution of exporting companies by the number of employees**



**Picture 54 Sample distribution of importing companies by the number of employees**



All data was collected during face to face interviews conducted by trained interviewers according to designed and piloted questionnaire. All interviews were conducted with

management of responding companies (director or deputies in charge of export operations). CID ensured 10% external quality control. Statistical analysis was done using SPSS program.

Four Focus Groups for exporting companies were conducted in different localities in Ukraine in May of 2004. These included Kherson, Kharkiv, Lviv, and Transcarpathian region. Two Focus groups for importing companies were conducted during the same time in Odesa and Kharkiv. All FG were conducted with 10-15 exporters or importers using designed template. Template entries were read and after short discussion data was entered only if consensus was established during each FG on each template entry. Mean data from four FG is presented in the report below.

There were 20 in-depth interviews with exporters and 20 in-depth interviews with importers conducted in the same regions as FG. All in-depth interviews were conducted by trained experts in face to face manner with directors of large enterprises. These interviews were also conducted according to the designed template.

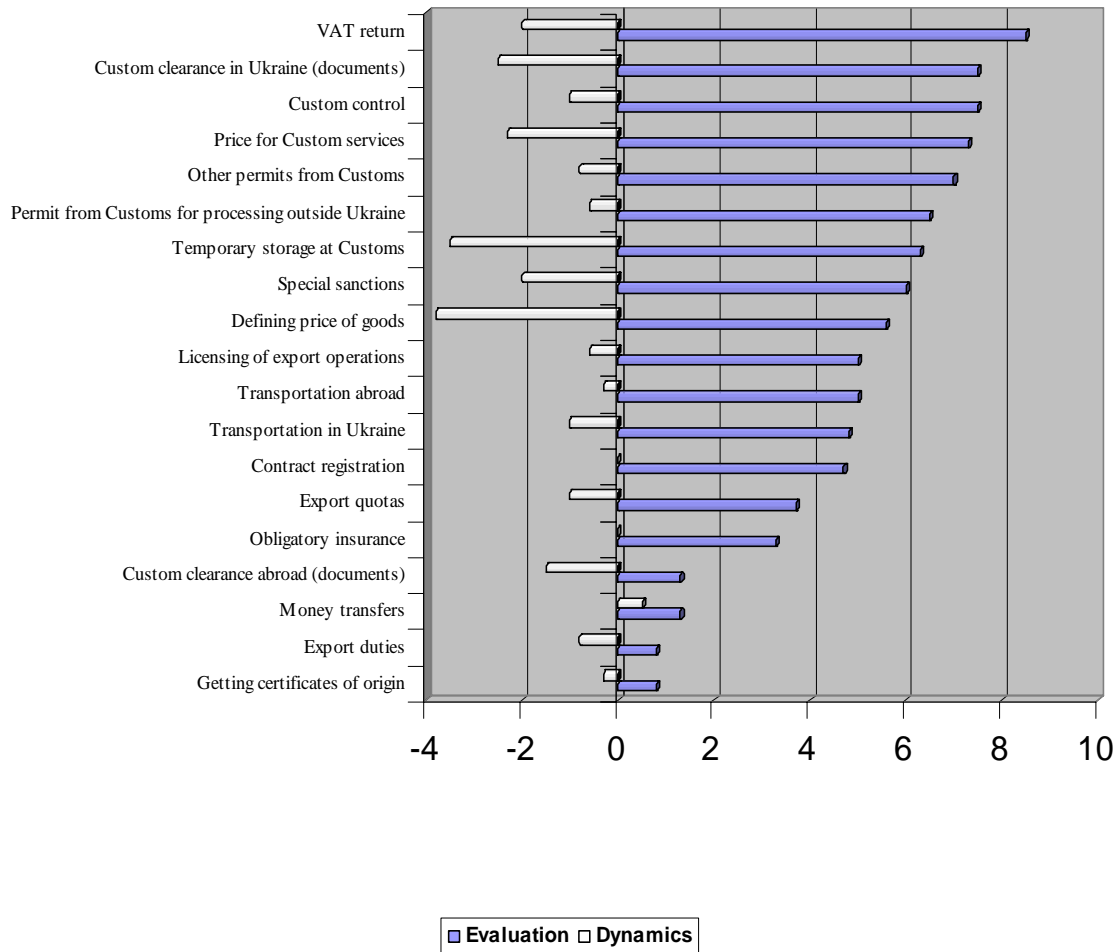
According to the quantitative surveys, average exporter in Ukraine conducts 26 export transactions with \$226,720 average annual export sales. Average importing company conducts 16.1 import transactions with \$314,094 average annual import transactions.

## 4.2. Export Regime

### 4.2.1. Overall evaluation

Picture 55 illustrates evaluation by Focus Groups participants of various elements of export regime in Ukraine as well as perception of dynamics of these elements during last year.

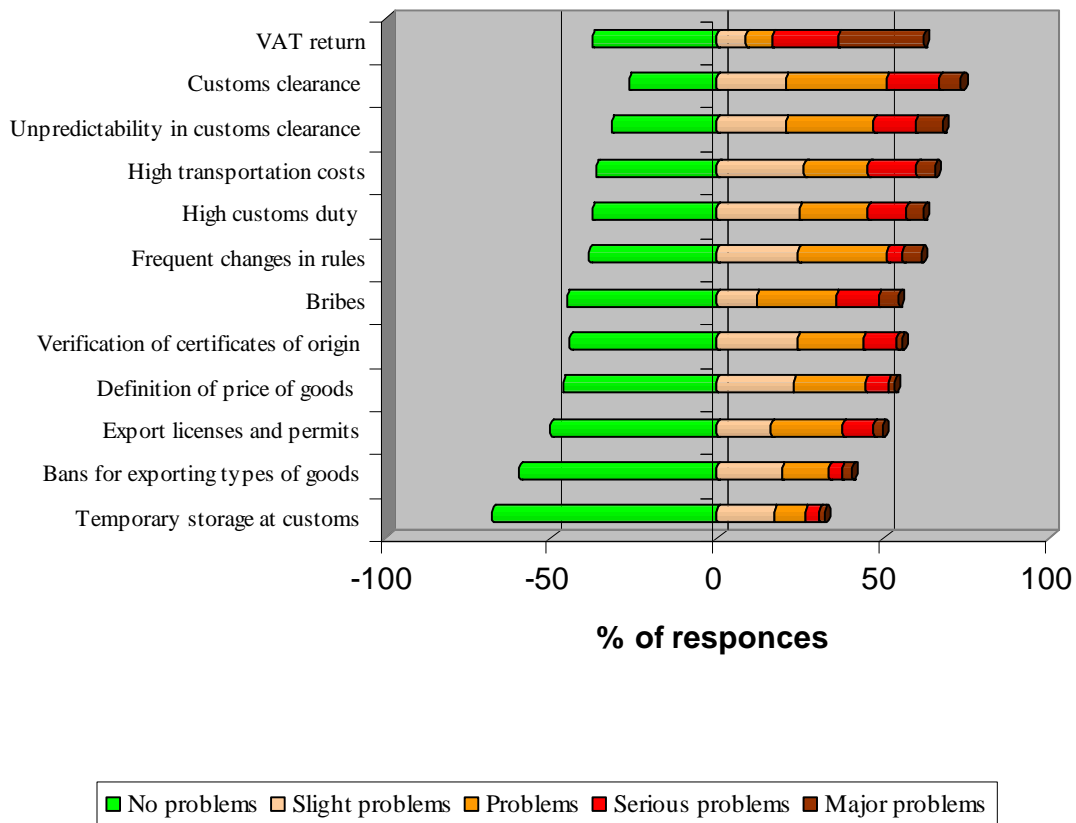
**Picture 55 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**



Similar question was asked during quantitative survey. Picture 56 illustrates data received from respondents. This data provides more depth into the issue of severity of problems as faced by individual businesses. Both methods provided consistent data. The

major problem areas relate to VAT return and Custom clearance. There are, however, two issues with mixed results. Transportation received more negative evaluation in the survey, while temporary Custom storage in the Focus Group.

**Picture 56 Evaluation of problem areas by survey respondents**



#### **4.2.2. Issue of VAT Return**

According to the FG participants, the issue of VAT return was the most problematic. There is also perception of significant deterioration of this issue over the last year. Almost all FG participants claimed that it is almost impossible to return VAT without informal requests and related corrupt practices. Also, application for VAT returns invites unwanted attention from inspecting agencies.

Quantitative survey data provide some benchmark data on the issue of VAT return. Only 34.5% of respondent reported applying for VAT return. And only 73.7% of them received such reimbursement. Furthermore, on average, this reimbursement was paid in

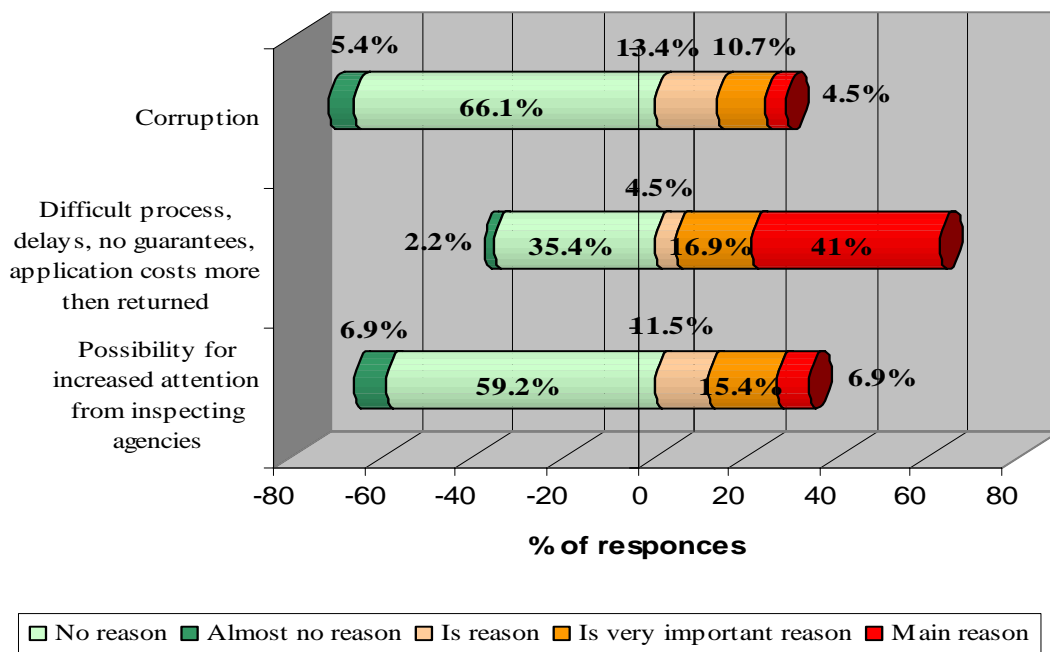
amount of 63% from applied sum. VAT return also incurred some additional expenses from businesses (see Table 15)<sup>6</sup>

**Table 15 Expenses related to VAT return**

	Made payments	Amount
Services of lawyers and intermediaries	11.3%	\$103.8
Unofficial payments	9.2%	-

60.9% of respondents claimed that after they filed application for VAT return, attention to them from various inspecting agencies increased. Such increased attention and perception that it can be possible is one of the reasons why only 65.5% of exporters in Ukraine (as reported in the survey) did not apply for VAT return. 33.8% of respondents named this as reasons why they did not apply for VAT returns (see Picture 57). Difficult process, delays, no guarantees, application costs more then returned VAT were named by more respondents as influencing their decision not to apply for VAT returns (62.4%). While 28.6% reported that their decisions not to apply for VAT return was influenced by highly corrupt process of application.

**Picture 57 Reasons for not applying for VAT return**



In depth interviews with larger companies corroborate these findings. Almost all directors claimed that VAT return is very serious problem. Only in the cases when it is reimbursed against arrears it is not considered to be problematic. Most complaints

<sup>6</sup> Here and below all data on time and expenses reflects one transaction if other is not specified.

related to artificial and significant decreasing of cash flow. There were also claims that this can lead to insolvency of otherwise successful and relative large companies. The reasons for not returning VAT almost unanimously were related to corruption of state officials.

### **4.2.3. Custom Clearance**

The issue of VAT return is closely followed by filing documents for custom clearance in Ukraine, Customs control, price for Custom services, and other permits from Customs (see Picture 55). Again, all these issues showed deterioration over the last year. FG participants mostly referred to unjustified requirements, expensive procedures, lost time and significant corruption at Customs as main reasons for such negative evaluation of procedures associated with Custom clearance. High prices for Custom services received most comments. They referred mostly to arbitrary and selective application of services and charging for them unjustifiably high prices. It is interesting to note that another charge that is supposed to go to the budget, namely export duties received one of the lowest grades.

According to the survey, in 2004 Custom clearance took on average 3.2 days for one clearance. This number is comparable with data obtained by the World Bank CODB study in 2002 in Ukraine (4.3 days). During this process, exporting companies incurred some administrative expenses (see Table 16). Overall one Custom clearance costs exporters on average \$156.6 in administrative costs (this excludes duties and taxes).

**Table 16 Administrative expenses for one average Custom clearance**

	<b>Made payments</b>	<b>Amount</b>
Forms, filling the forms	71.0%	\$41.6
Other official payments (except custom duties and excises)	75.3%	\$107.4
Penalties (fines and confiscations)	3.7%	\$141.7
Services of lawyers and intermediaries	25.4%	\$115.1
Unofficial payments to Customs	7.4%	\$93.5
<b>Overall</b>	<b>90.4%</b>	<b>\$156.6</b>

According to the survey respondents, most common expense at clearing customs is purchase of forms and filling them as well as numerous other official payments in addition to mentioned. Relatively small % of respondents that claimed that sanctions were used can be explained by numerous other instances except Customs itself where sanctions can be applied. Some of such instances are described below.

In-depth interviews with larger companies informed that for them customs clearance itself is usually insignificant problem. In most cases they either rely on all inclusive services of custom brokers or have full time departments that deal with these issues for a long period of time. According to the survey, 53.9% of respondents used services of Custom brokers.

#### **4.2.4. Preliminary Registrations and Receiving Permits**

Export regime is characterized by numerous requirements and rules not only for clearing Customs itself, but for preliminary registrations and receiving permits for otherwise fully legalized companies that are planning to engage in export activities. Not all companies are required to pass these procedures. Regulatory coverage for preliminary registrations and permits is illustrated in Picture 7. Registration as exporters has greatest coverage, 73.8% of all respondents underwent through this procedure. This is followed by registration of contracts for export operations (24.1%) and export licenses (20.6%). Large number of additional permits cumulatively account for 40.9% of responses although individually they are not as widespread as presented above requirements.

These requirements carry quite significant regulatory burden for exporting companies. These are summarized in Table 17. All data is related to one-time application of requirements.

**Table 17 Regulatory burden of preliminary export permits and registrations**

	<b>Share of firms that received permits</b>	<b>Time spent</b>	<b>Made official payments</b>	<b>Amount of official payments</b>
Registration as exporters	73.8%	4.2 days	54.6%	\$43.3
Receiving other permits	40.9%	10.7 days	95.8%	\$95.8
Registration of contracts	24.1%	3.8 days	36.1%	\$60.5
Export license	20.6%	10.7 days	38.4%	\$184.5
Receiving NBU licenses	11.1%	4.9 days	23.4%	\$70.2
<b>Overall</b>	<b>78.1%</b>		<b>68.5%</b>	<b>\$144.1</b>

In addition to spending time and making official payments, businesses frequently also faced administrative corruption in the form of need to pay informally. Table 18 summarizes these data for preliminary requirements.

**Table 18 Administrative corruption in preliminary export permits and registrations**

	<b>Made informal payments</b>	<b>Amount of informal payments</b>
Registration as exporters	3.8%	\$65.3
Receiving other permits	23.3%	\$104.8
Registration of contracts	1%	-
Export license	1%	-
Receiving NBU licenses	0%	-

It is interesting to observe that question on other permits received by far more affirmative answers on informal payments. The reason for this can be that the question was

formulated without naming specific agencies and respondents were ready to answer it without fear.

Focus Groups findings and in-depth interviews inform that contract registration is mostly believed to be absolutely unnecessary burden on businesses. Requirements for licensing and quotas are believed to change to frequently. FG noted increase in the number of goods that require licensing to export.

#### **4.2.5. Contract Monitoring**

24.7% of all respondents claimed that state agencies monitor conditions and fulfillment of their contracts. State agencies in such cases monitor if payments on contracts are made in timely manner and punish receiving side if they are not. Expenses that businesses incur due to such contract monitoring are presented in Table 19. Overall, expenses related to contracts monitoring amount to \$146.1.

**Table 19 Expenses related to contract monitoring**

	<b>Made payments</b>	<b>Amount</b>
Fines and confiscations	15.7%	\$80.0
Services of lawyers and intermediaries	6.4%	\$125.8
Unofficial payments	3.8%	-

#### **4.2.6. Use of Special Sanctions**

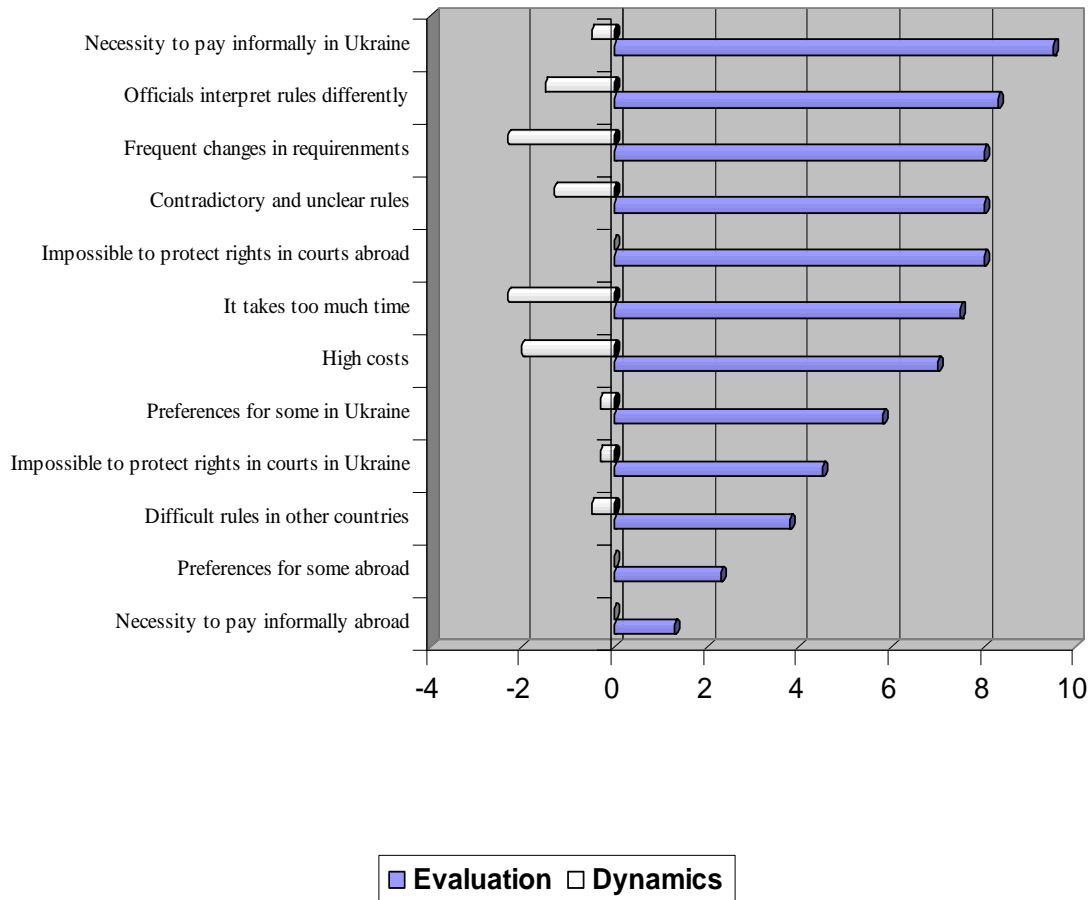
An example of arbitrary enforcement is use of so-called special sanctions which are related to complete stoppage of export activities or individual licensing regime. FG reported either automatic use of them or application of these sanctions for minor irregularities. Removal of special sanctions is most arbitrary and is connected to demands for informal payments. Subjectivity is also noted in definition of prices of exported goods. FG reported arbitrary definition of codes, usage of unclear and unknown precedents and plain demands for informal payments. Quantitative survey indicates that as much as 4.7% of polled companies were subjected to special sanctions.

#### **4.2.7. Evaluation of Causes for Negative Regulatory Environment for Export Operations**

Data received from FG on evaluation of elements of export regime in Ukraine and especially on the reasons for negative evaluation correlates with evaluation by the FG of the possible negative characteristics or causes for negative regulatory environment for export operations.

Picture 58 illustrates such evaluation by FG participants as well as perception of dynamics of these characteristics during last year.

**Picture 58 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**

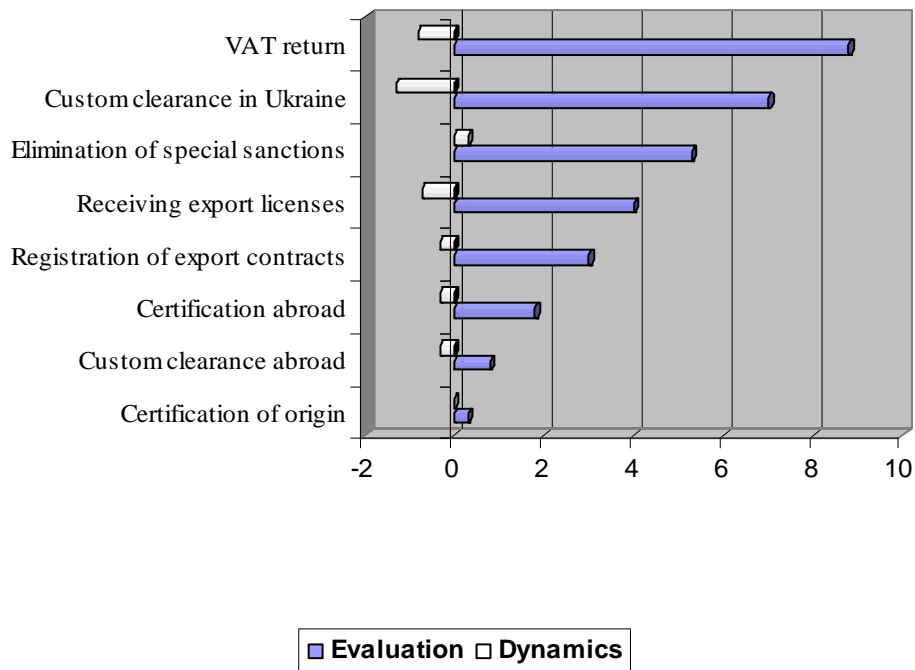


Necessity to pay informally as well as related to this arbitrary interpretation of rules and requirements by officials which use frequently changing and unclear rules received most negative grades. Comments received during FG referred to the practice of informal payments as “all the time” and “total.” Insignificant negative dynamics for informal payments was explained by “nowhere to go down” argument.

Newly adopted Customs Code accounted for majority of negative evaluations for frequent changes and contradictions in rules and requirements. It was specifically noted that there are currently numerous contradictions between this Code and other Laws.

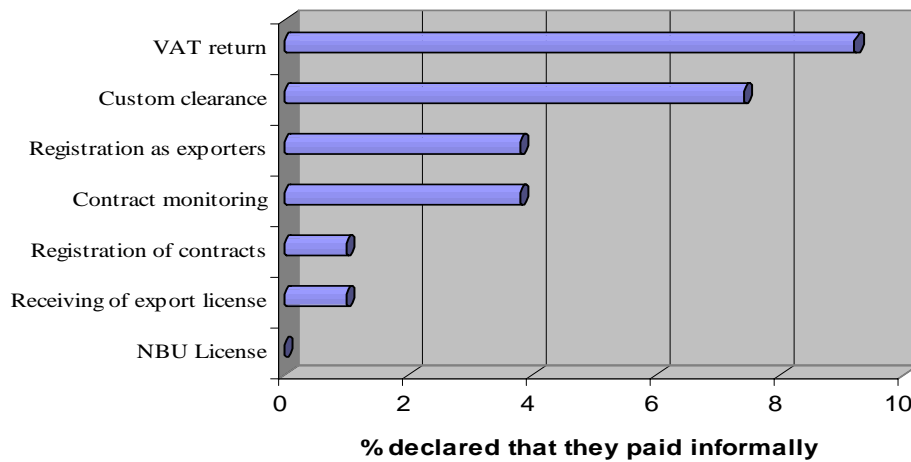
FG participants were also asked to evaluate corruption levels for specific procedures they are fulfilling. Picture 59 presents these data in the form of 10 point scale evaluation of corruption levels and perception of annual changes. Data is fully consistent with presented above data and arguments. VAT return and Customs clearance in Ukraine are most corrupt practices as reported by FG participants.

**Picture 59 Evaluation of corruption (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**



This data almost completely correlates with quantitative survey data on % of respondents that declared that they paid informally in different agencies (Picture 60). VAT return procedures and Custom clearance are also featured here as most corrupt. It is important to note that % that reported informal payments indicator has mostly comparative value. It is assumed that for all agencies the level of error in this indicator is similar. In other words, reported data does not mean that there are only 9.2% businesses that pay bribes for VAT return. Most probably this number is different and higher. This data, however means that there are more instances of bribery for VAT return than for all other measured procedures.

**Picture 60 Informal payments as reported by the survey respondents**

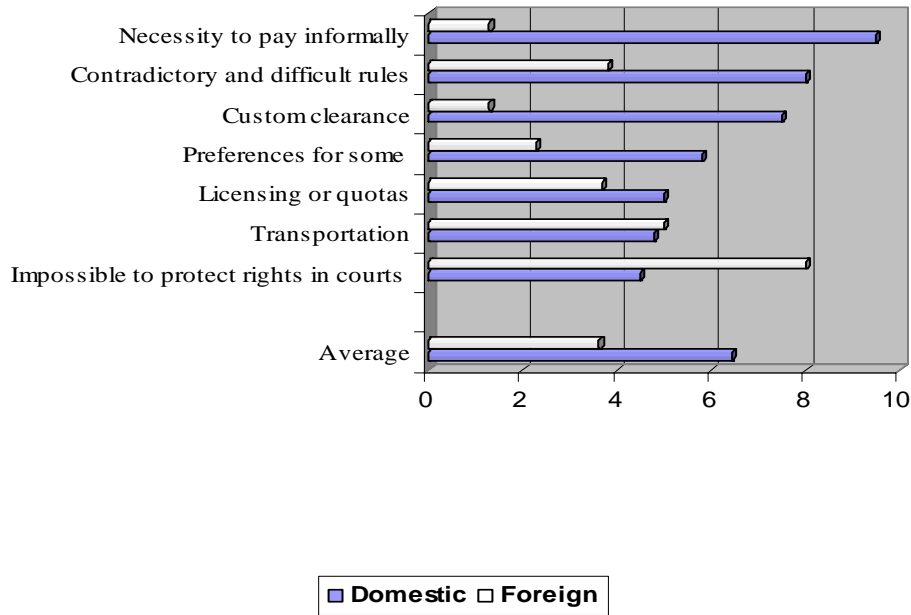


#### **4.2.8. Domestic vs. Foreign Problems**

FG data provides observer with interesting insight. There is relatively intensive discussion about discrimination of Ukrainian exporters abroad and related necessity to protect their rights. Moreover, there are numerous arguments proposing more proactive state policies for promoting Ukrainian companies and goods. The question one can ask is whether Ukrainian exporters face more problems abroad or domestically.

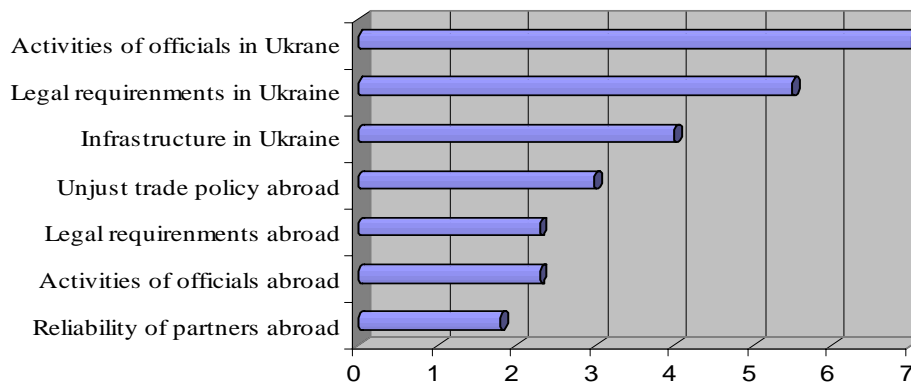
FG data clearly shows that Ukrainian businesses that are engaged in export operations face significantly more problems at home than abroad. FG template provides 7 comparable pairs of issues for evaluation. Average evaluation of these pairs shows that domestic issues receive 6.4 points on 10 point scale while foreign issues receive only 3.6 points (see Picture 61). Moreover, if protection in courts is omitted, the difference is almost 2.3 times (6.8 and 3 points respectively). Finally, almost in all comments FG participants noted that main difficulties abroad were in Russia. It means that without Russia difference in attitudes would be even greater.

**Picture 61 Differences in evaluation of pairs of issues (0-10 scale where 0 is no problems and 10 – very significant problems).**



Finally, all data above correlates with FG results from the last question on overall evaluation of export regime (Picture 62).

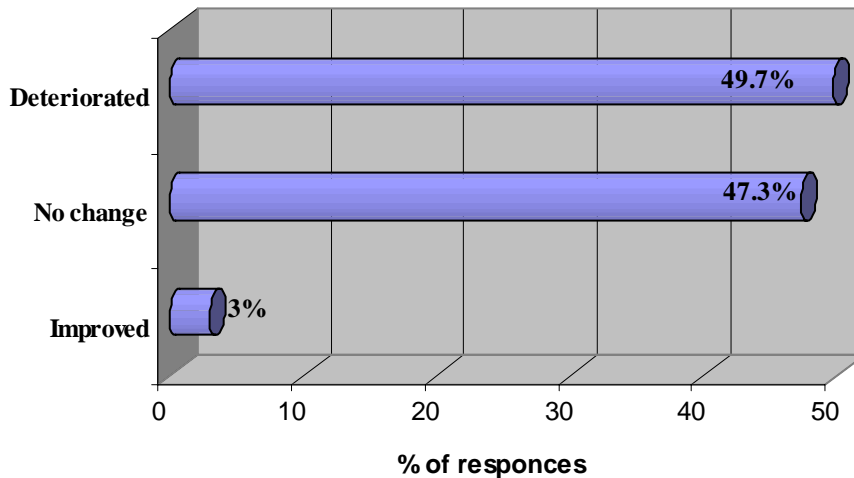
**Picture 62 Evaluation of regime (0-10 scale where 0 is no problems and 10 – very significant problems)**



#### **4.2.9 Perception of Change**

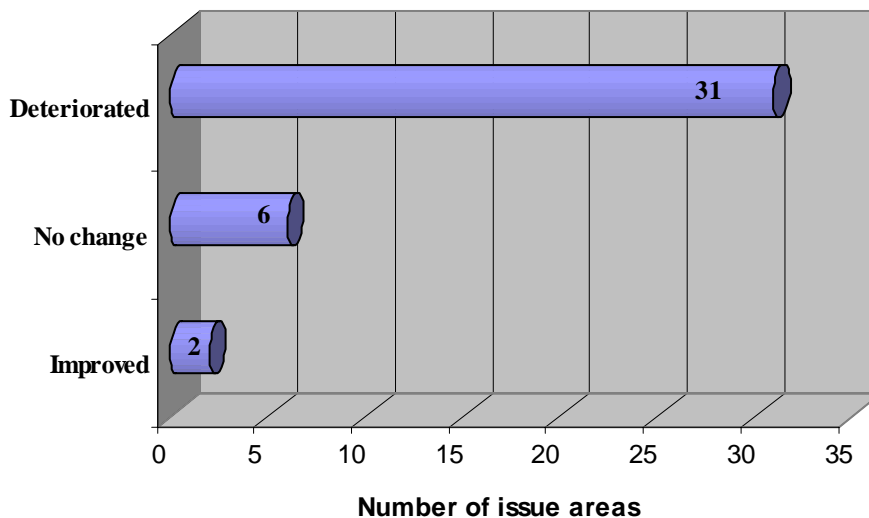
Both, FG participants and Survey respondents were unanimous that there were no improvements in Export regime during last 12 months. Picture 63 illustrates perception of the survey respondents on the dynamics of export regime. Slightly more respondents believe that regime deteriorated during last year.

**Picture 63 Perception of the survey respondents on the dynamics of export regime**



Picture 64 illustrates number of issues of export regime that were evaluated by Focus Group participants. By issues there is clear perception of deterioration during last year.

**Picture 64 Evaluation of dynamics in issue-areas by FG participants**



#### **4.2.10. Conclusions for the Part One: Policy Ramifications**

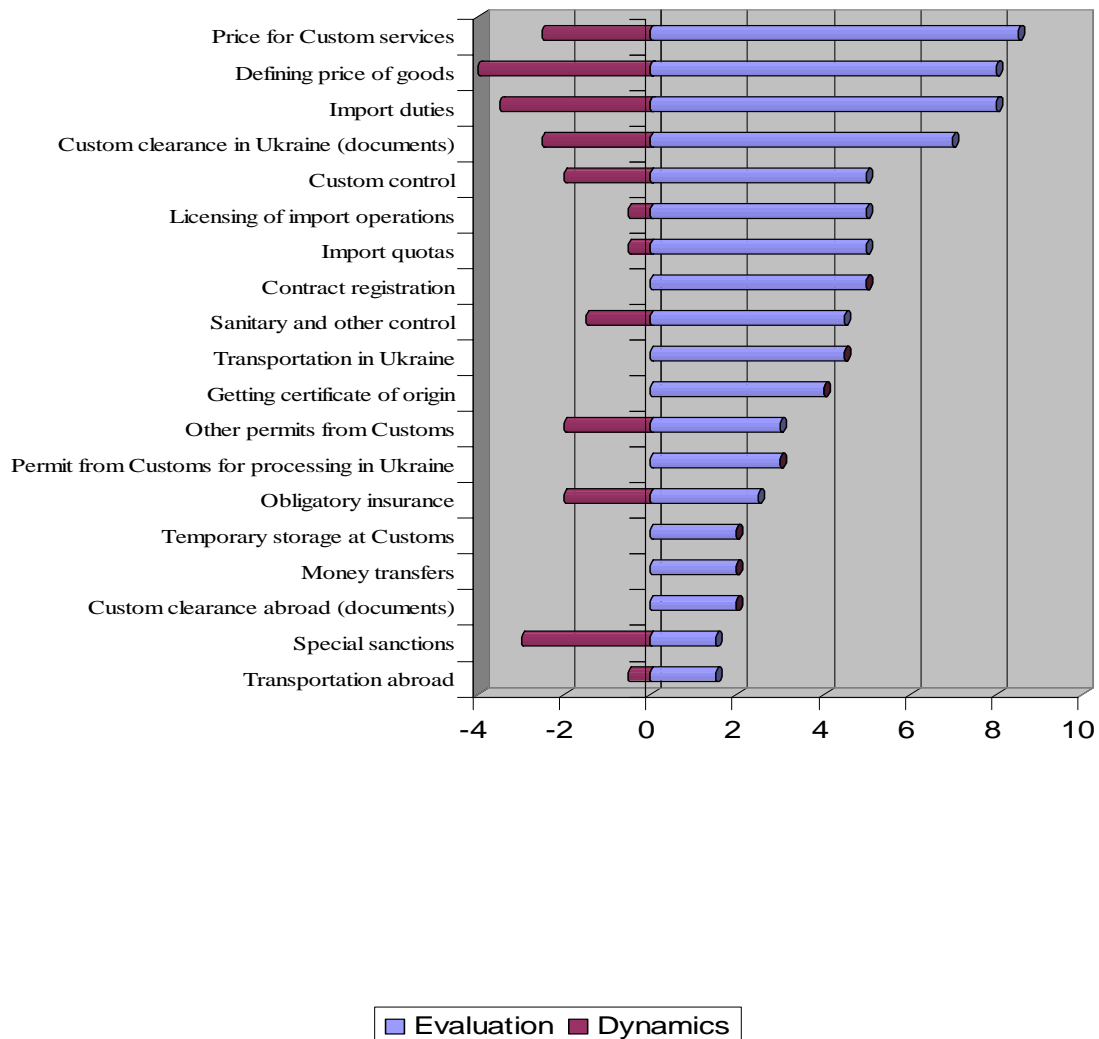
1. Main problems that need to be addressed at the Governmental level in the area of export regime almost exclusively relate to domestic issues.
2. Of these, most important that need immediate attention are almost total corruption at Customs and the issue of VAT return.
3. In order to reduce opportunities for arbitrary application of laws, comprehensive review of all Custom Code and related laws is needed for elimination of contradictions.
4. As for non-domestic issues the only important one is promoting capacity for effective protection of Ukrainian companies in courts abroad.

### 4.3. Import Regime

#### 4.3.1. Overall evaluation

Picture 65 illustrates evaluation by Focus Groups participants of various elements of import regime in Ukraine as well as perception of dynamics of these elements during last year.

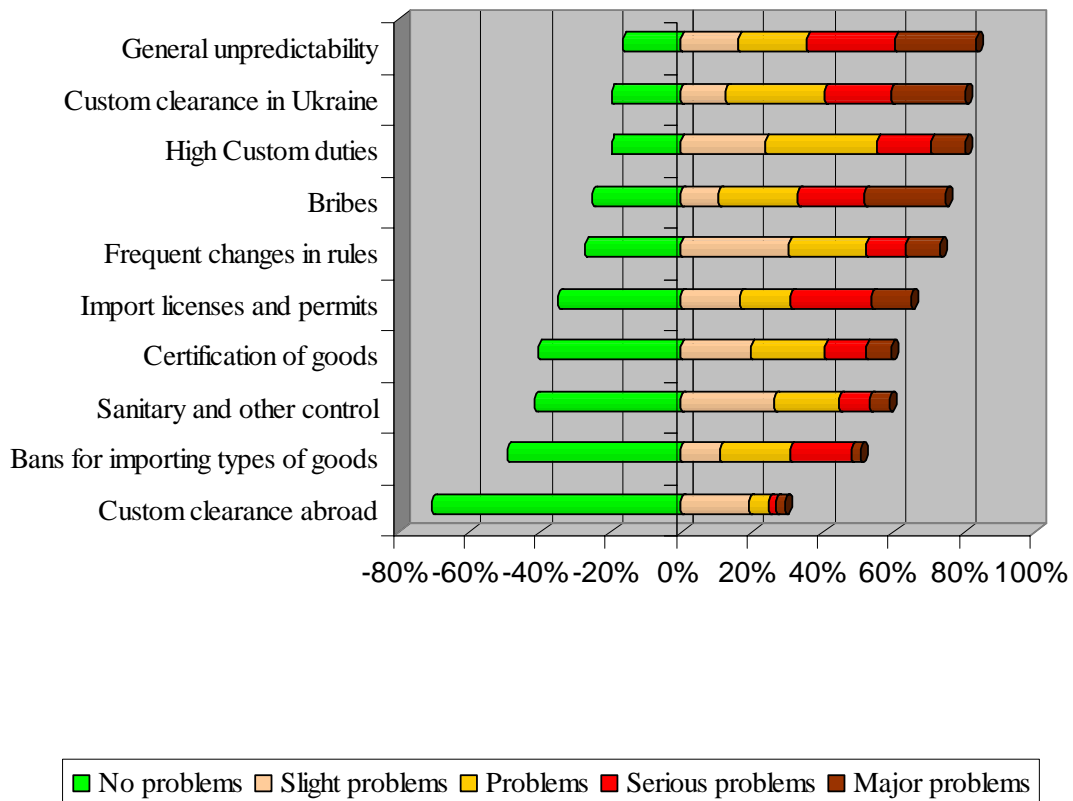
**Picture 65 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**



Definition of prices for imported goods received most negative response on dynamics and it virtually tied with Import duties and prices for Custom services as most difficult issues of import regime. Actual Custom clearance in Ukraine also received significantly negative evaluations.

A number of similar question was asked during quantitative survey. Picture 66 illustrates data received from respondents. This data provides more depth into the issue of severity of problems as faced by individual businesses. Both methods provided consistent data. The major problem areas relate to Custom clearance and high Custom duties.

**Picture 66 Evaluation of problem areas by survey respondents**



#### **4.3.2. Preliminary Permits and registrations**

In addition to actual clearing Customs, Ukrainian importing companies must undergo myriad of preliminary or additional procedures. Overall it takes approximately 34.8 days and costs on average \$243.2 to pass one round of these procedures. Table 20 illustrates time and official expenses related to these procedures. Registration as importer in Customs ranked as most widespread procedure with highest coverage (81% of

respondents had to register as importers). By coverage this is followed by receiving sanitary permits and Permits from the Ministry of Ecology.

**Table 20 Preliminary permits and registrations, official expenses**

	Had to undergo the process	Time, days	Made official payments	Amount of official payments
Registration as importer	81%	3.1	37.6%	\$44.1
Sanitary permit	65.3%	14.5	79.8%	\$95.6
Ministry of Ecology permits	64.5%	2.6	69.9%	\$18.5
Contract registration	27.4%	2	42.9%	\$81.8
Phito Sanitary certificate	27.4%	4	50.8%	\$71.9
Receiving NBU license	27%	15.3	30.9%	\$76.8
Import license MOE	21.8%	9.2	37.9%	\$88.7
Other permits	73.1%	15.3	98.2%	\$115.8

In addition to official expenses for preliminary permits and registrations, importing companies incur informal expenses as well. How widespread this practice is by agency is represented in Table 21. Due to relatively small response rate on actual amount of informal payments, it is impossible to calculate average data by agency. However, overall bribes as reported by respondents ranged from 50 to 150 Hryvnias (approximately \$10-30).

**Table 21 Preliminary permits and registrations, informal expenses**

	Made informal payments
Registration as importer	6.4%
Sanitary permit	5.1%
Ministry of Ecology permits	4.9%
Contract registration	1.8%
Phito Sanitary certificate	6.2%
Receiving NBU license	-
Import license MOE	1.5%
Other permits	7%

Customs ranked comparatively as agency, officials of which most frequently accepted bribes for preliminary permits and registrations. On the other hand, all respondents claimed that receiving license from NBU was done without informal payments. Receiving licenses from the Ministry of Economy and contract registration also yielded extremely small numbers of informal payments occurrences.

### **4.3.3. Certification of Imported Goods**

Discussions with entrepreneurs, other anecdotal evidence in Ukraine during a number of last years suggested that one of the significant problems faced by importing companies

relate to the issue of Certification of imported goods. Therefore, the current study addressed this issue in greater detail. According to quantitative survey, 45.2% of importing companies had to undergo certification process which took on average 8.2 days and incurred expenses of \$193.3 for one operation.<sup>7</sup> Indeed if compared to other preliminary permits or registrations, certification is the most expensive and takes relatively long period of time to complete. Regulatory coverage however is not as high as for other permits. This can be explained by recognition of some foreign standards by Ukrainian authorities. 92.2% of respondents reported that they had certificates of origin for the goods they imported. Therefore, one can say that approximately only in half of all cases foreign certificates are recognized in Ukraine.

Table 22 illustrates distribution of payments for certification.

**Table 22 Certification Costs**

	Made payments	Amount of payments
Official fees	-	\$95.3
Expertise and analysis	74.5%	\$84.0
Notary	38.2%	\$26.2
Lawyers and intermediaries	27.3%	\$138.9
“Voluntary” contributions	8.9%	-
Informal payments	10.7%	-

The most expensive category is usage of lawyers and intermediaries with almost one third of all importing companies using such services. In 2002, only 14.3% of respondents used such services.<sup>8</sup> Survey also indicated comparatively to other agencies, respondents reported relatively high level of occurrence of informal payments as well as existence of the practice of “voluntary” contributions. Although both these indicators declined from 2002 when 16.1% declared paying informally and 10.8% made “voluntary” contributions.

#### **4.3.4. Custom Clearance**

Actual Custom clearance for importing companies ranked as most problematic according to the Focus Groups participants. It also showed significant deterioration in perception over the last year. FG participants and qualitative interview respondents mostly referred to the unclear and frequently arbitrary definition of prices of goods for duties, lost time and significant corruption at Customs as main reasons for such negative evaluation of procedures associated with Custom clearance. High prices for Custom services also

<sup>7</sup> According to CODB survey conducted by the World Bank, in 2002 ([http://www-wds.worldbank.org/servlet/WDSContentServer/WDS/IB/2003/12/05/000160016\\_20031205153539/Rend ered/PDF/272440English0CODB0Ukraine00201public1.pdf](http://www-wds.worldbank.org/servlet/WDSContentServer/WDS/IB/2003/12/05/000160016_20031205153539/Rend ered/PDF/272440English0CODB0Ukraine00201public1.pdf)), 71.4% of importing companies had to receive certificates for imported goods. It took 1.8 days and cost of \$346. These data can be compared to 2004 survey data only for illustrative reasons due to significant differences in sample sizes.

<sup>8</sup> Ibid.

received negative comments. They referred mostly to arbitrary and selective application of services and charging for them unjustifiably high prices.

According to the survey, in 2004 Custom clearance for imports took on average 4.9 days for one clearance. This number is comparable with data obtained by the World Bank CODB study in 2002 in Ukraine (5.3 days)<sup>9</sup>. During this process, importing companies incurred some administrative expenses (see Table 23). Overall one Custom clearance costs importers on average \$132.4 in administrative costs (this excludes duties and taxes).

**Table 23 Administrative expenses for one average Custom clearance (one import operation)**

	<b>Made payments</b>	<b>Amount</b>
Forms, filling the forms	85.8%	\$9.0
Other official payments (except custom duties and excises)	65.8%	\$65.4
Penalties (fines and confiscations)	2.5%	-
Services of lawyers and intermediaries	28.3%	\$128.8
Unofficial payments to Customs	11.7%	\$107.2

According to the survey respondents, most common expense at clearing customs is purchase of forms and filling them as well as numerous other official payments in addition to mentioned. Relatively small % of respondents that claimed that sanctions were used can be explained by numerous other instances except Customs itself where sanctions can be applied.

In-depth interviews with larger companies informed that for them customs clearance itself is usually insignificant problem. In most cases they either rely on all inclusive services of custom brokers or have full time departments that deal with these issues for a long period of time. According to the survey, 62.1% of respondents used services of Custom brokers.

#### **4.3.5. Evaluation of Causes for Negative Regulatory Environment for Import Operations**

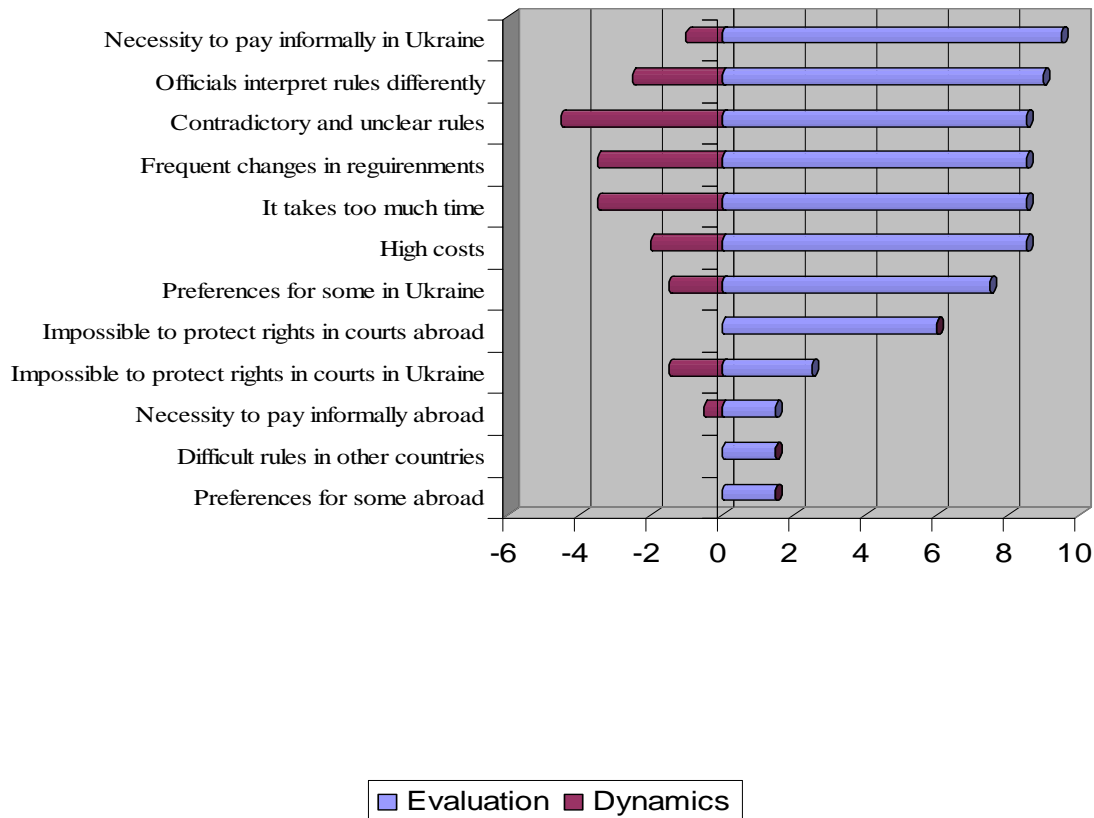
Data received from FG on evaluation of elements of import regime in Ukraine and especially on the reasons for negative evaluation correlates with evaluation by the FG of the possible negative characteristics or causes for negative regulatory environment for import operations.

Picture 67 illustrates such evaluation by FG participants as well as perception of dynamics of these characteristics during last year.

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<sup>9</sup> Ibid.

**Picture 67 Evaluation (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**



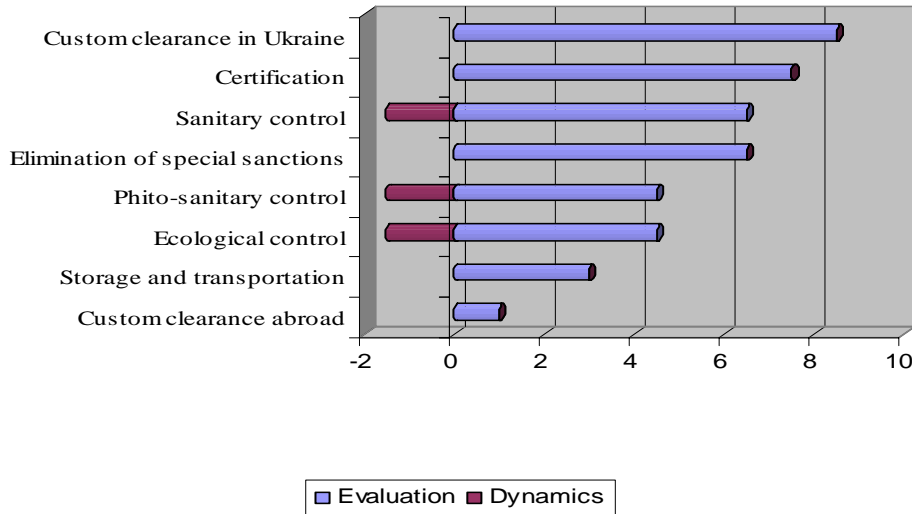
Necessity to pay informally in Ukraine as well as related to this arbitrary interpretation of rules and requirements by officials which use frequently changing and unclear rules received most negative grades. Comments received during FG and qualitative interviews referred to the practice of informal payments as “all the time” and “total.” Insignificant negative dynamics for informal payments was explained by “nowhere to go down” argument. This data is strikingly similar to data reported by exporting companies in Ukraine.

Again, like for exporting companies, Newly adopted Customs Code accounted for majority of negative evaluations for frequent changes and contradictions in rules and requirements. It was specifically noted by the qualitative interviews participants that there are currently numerous contradictions between this Code and other Laws.

FG participants were also asked to evaluate corruption levels for specific procedures they are fulfilling. Picture 68 presents these data in the form of 10 point scale evaluation of

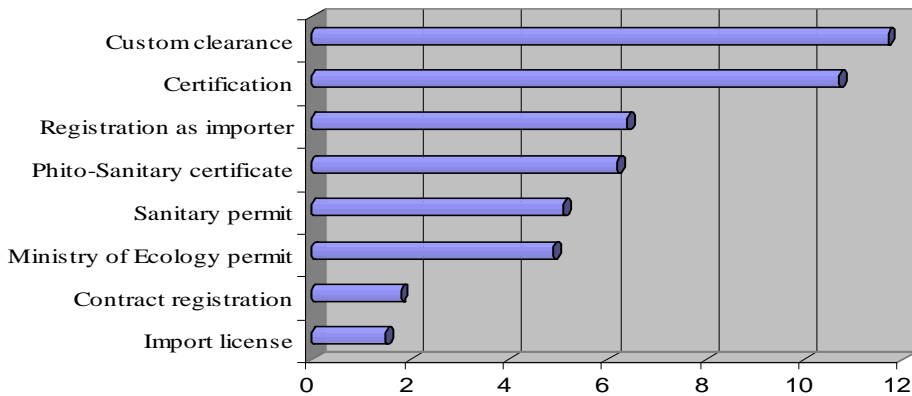
corruption levels and perception of annual changes. Customs clearance and certification of imported goods in Ukraine are most corrupt practices as reported by FG participants.

**Picture 68 Evaluation of corruption (0-10 scale where 0 is no problems and 10 – very significant problems) and dynamics (-5 to 5 scale where -5 significant negative changes, 0 – no changes and 5 – significant positive changes during last calendar year.**



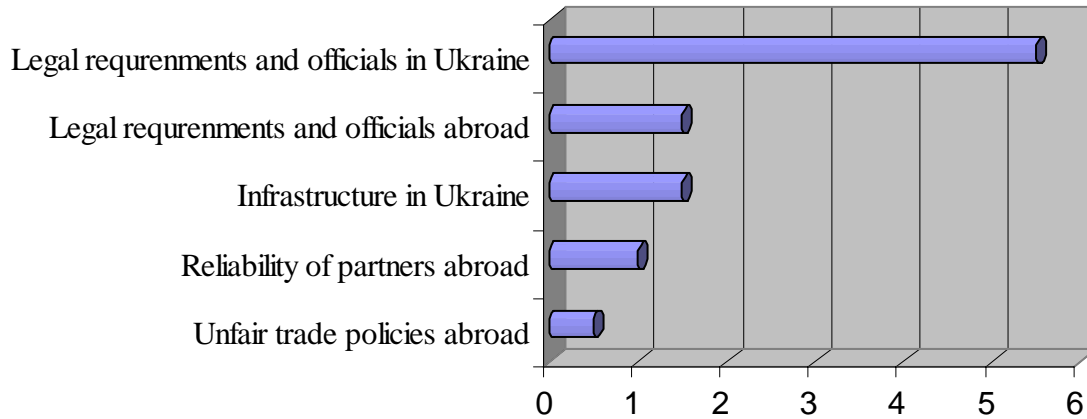
This data almost completely correlates with quantitative survey data on % of respondents that declared that they paid informally in different agencies (Picture 69). Custom clearance and Certification are also featured here as most corrupt. It is important to note that % that reported informal payments indicator has mostly comparative value. It is assumed that for all agencies the level of error in this indicator is similar.

**Picture 69 Informal payments as reported by the % of survey respondents**



Finally, all data above correlates with FG results from the last question on overall evaluation of export regime (Picture 70).

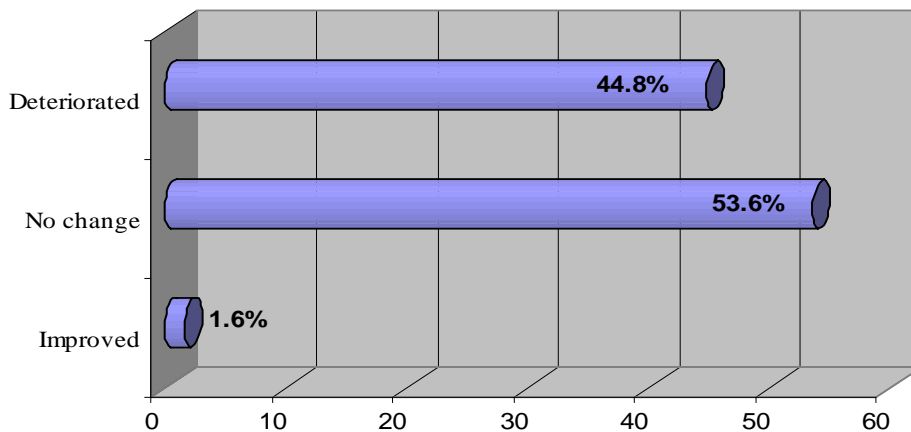
**Picture 70 Evaluation of import regime (0-10 scale where 0 is no problems and 10 – very significant problems)**



#### **4.3.6. Perception of Change**

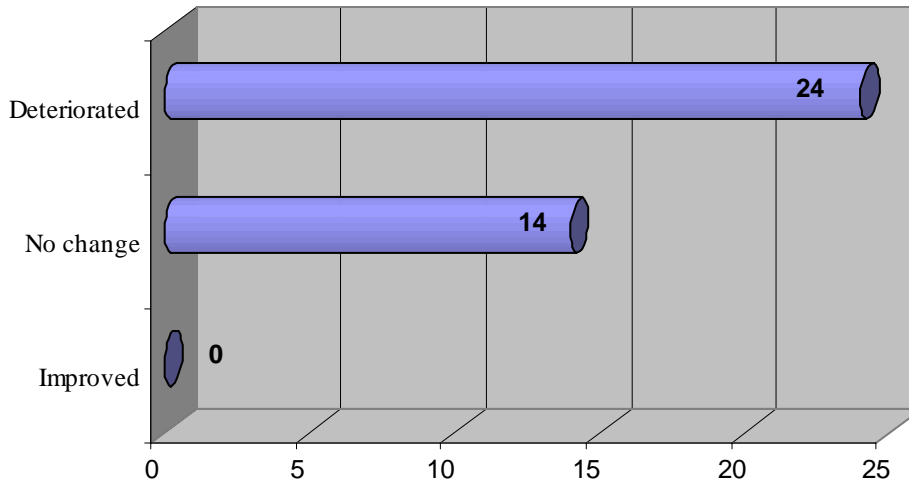
Both, FG participants and Survey respondents were unanimous that there were no improvements in import regime during last 12 months. Picture 71 illustrates perception of the survey respondents on the dynamics of export regime.

**Picture 71 Perception of the survey respondents on the dynamics of export regime**



Picture 72 illustrates number of issues of export regime that were evaluated by Focus Group participants. By issues there is clear perception of deterioration during last year.

**Picture 72 Evaluation of dynamics in issue-areas by FG participants**



#### **4.3.7. Conclusions for the Import Regime: Policy Ramifications**

1. Main problems that need to be addressed at the Governmental level in the area of import regime relate to Customs especially corruption and arbitrary interpretation of laws by Custom officials.
2. In order to reduce opportunities for arbitrary application of laws, comprehensive review of all Custom Code and related laws is needed for elimination of contradictions.
3. Additional permits and registrations are significant and according to respondents unnecessary barriers for Ukrainian companies to engage in international trade.