Ukrainian Automobile Production: Current State and Prospects for the Future

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Introduction

Over the last seven years the Ukrainian automobile industry has been receiving a particular attention from the side of the Government. The main purposes of such attention were (i) to give an additional impulse to the domestic production of cars; (ii) to secure future development of this sector based on the development of the existing industrial, scientific, technical and export potential of this industry and by creation of favourable conditions for the attraction of investments to this sector (both domestic and international).

Since the Ukrainian automobile industry is highly growing sector of the Ukrainian economy the other reason of the state to pay additional attention to this industry was to protect a domestic producers, which are less competitive compare with the international producers due to the number of different circumstances and particularly to the low technical level of production. At the same time, any development of the Ukrainian automobile industry in a long run becomes impossible without bringing national legislation into the line with the requirements of GATT/WTO and Partnership and Cooperation Agreement between Ukraine and the European Communities as well as their member states.

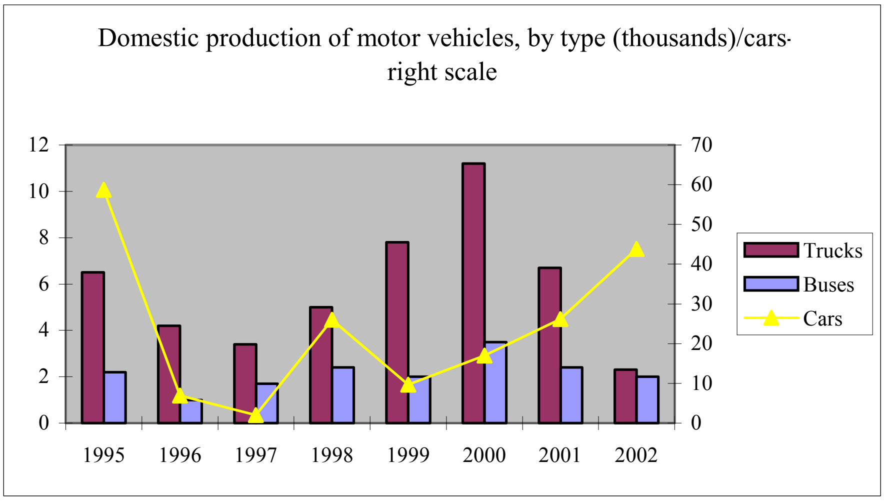
1. Ukrainian automobile industry overview

Ukrainian automobile industry is an important contributor to the country's economy. By different estimation this industry obtains around 2% of the country's GDP.[1] The Ukrainian automobile production consists from the three types of products: (i) cars, (ii) trucks, (iii) buses. Although trucks and buses are important components of the automobile industry, this work is concentrated only on a passenger vehicles component.

Cars production has the highest weight in the total automobile production. In 2002 cars production share had reached its peak over the last decade. In 2002, it was accounted around 91% of the total production against 87% in 1995.[2] Although over the last 8 years the increase in importance of the cars production seems insignificant, the very significant fluctuations have taken place. During this period the lowest

[1] Based on the State Statistical committee data
[2] Ukraine in Numbers. Annual Statistical Yearbook. 2002

number of cars was produced in 1997 (28% of the totally produced automobiles in the country).[3]



Source: Ukrainian Ministry of Industrial Policy

Since the domestic market demand for cars has been constantly growing over the last 8 years, some decrease in the local production was compensated by increase in imported cars. However, the share of imported cars in the total amount of the goods import to the country has been remaining almost on the same stable level of between 2% and 3%.[4] Nevertheless, such stability does not mean that number of the imported cars remains on the same level as before.

In addition to its importance as a GDP contributor, Ukrainian automobile industry is an important contributor to the country's labour market. According to the statistical data the direct employment in this sector reaches around 30,000 people.[5] Although it accounts to around 1% of all jobs in the economy, the number of those who are employed by this sector indirectly (i.e., steel, glass makers, motor works, service sector) can be significantly higher.[6]

[3] Same as in 2
[4] Ukraine in Numbers. Annual Statistical Yearbook. 2002
[5] Data Ministry of Labour and Social Protection
[6] For example, in Germany number of people who are employed in this sector of economy is more than 800,000. (Data as on the end-1997/Statistical office)

2. Cars' market analysis

2.1. Domestic production

The dispersion of the domestic production of cars is very low. Basically, it is concentrated in four main companies:

- Kremenchug auto assembling manufactory (KRASZ);
- Eurocar;
- Lutsk automobile plant (LUAZ);
- Zaporozhia Automobile Building Plant (ZAZ)

With the only exception of Eurocar these companies has been traditionally specialized in the car manufacturing. Eurocar is the new and highly growing USD15 million investments projected. It was established as an assembly plant at the city of Uzhhorod, Zakarpattya Oblast to produce Skodas. In 2003 a new agreement with Volkswagen provided the opportunity for the Passat assembly. In the second half of 2003 the Skoda Superb was also added to the portfolio.[7]

The Kremenchug company has been using the existing facilities of the Kremenchug auto assembling manufactory. The company, which traditionally specialized in the production of the UAZ, has been starting to produce GAZ (Volgas) since 2001. In November 2002 company started VAZ assembly.[8]

Lutsk automobile plant is one of the oldest in Ukraine. It was established in the 1960s to produce a small jeep-like off-roader. Now LuAZ assembles UAZ-jeeps in addition to Lada cars (VAZ). Although main activity of the company is assembling the aforementioned cars, they also have a self-designed off-roaders.

AvtoZAZ has been producing self-designed Tavria cars for a few years was a partner of Daewoo Motors but then the plant was not included in the Daewoo-GM agreement. It comes as no surprise then that the name of the company was changed from AvtoZAZ-Daewoo to just plain ZAZ (Zaporozhia Automobile Building Plant) in January 2003. ZAZ assembles various cars, like Mercedes-Benz, Opel and from 2004 GM-Daewoo products (budged locally as Chevrolet). Part of an ambitious expansion program, ZAZ is now exclusive CKD assembler of the VAZ Samara I family. CKD assembly of the Opel Astra T300 commenced in February, 2004. Parts are afoot to bring production of the Daewoo Lanos/Sens under one roof - so from November 2004

[7] Data of the Ministry of the Industrial Policy
[8] Data of the Ministry of the Industrial Policy

this type has been producing locally. In 2003 ZAZ co-operated with 537 Ukrainian component manufacturers, 80 Russian, and 47 component manufacturers of the other foreign countries. During 2003 ZAZ contribution to the budget of the country is more than 120 million UAH.[9]

As in any other country, which produces cars, the Ukrainian domestic supply of cars goes in two forms:

- full-cycle production (purely domestic production)
- production based on the assembling of the imported parts.

As international experience suggests, the higher the share of the first component the bigger the share of the industry in the country's GDP. Consequently, the number of employment generated by the automobile industry also increases. However, the analysis shows that mostly all domestic car producers simply import all the assembling parts. And then do assembling of their vehicles on a territory of Ukraine.

The study shows that around 20% of the passenger vehicles were fully produced in Ukraine. Correspondently, 80% were assembling in Ukraine. The largest domestic producer in 2003 was Zaporozhia Automobile Building Plant (ZAZ). 76% of this company's output was fully produced in Ukraine (full-cycle production) – see table below.

*Table. Structure of production by Ukrainian automobile makers in **2003**, in %*

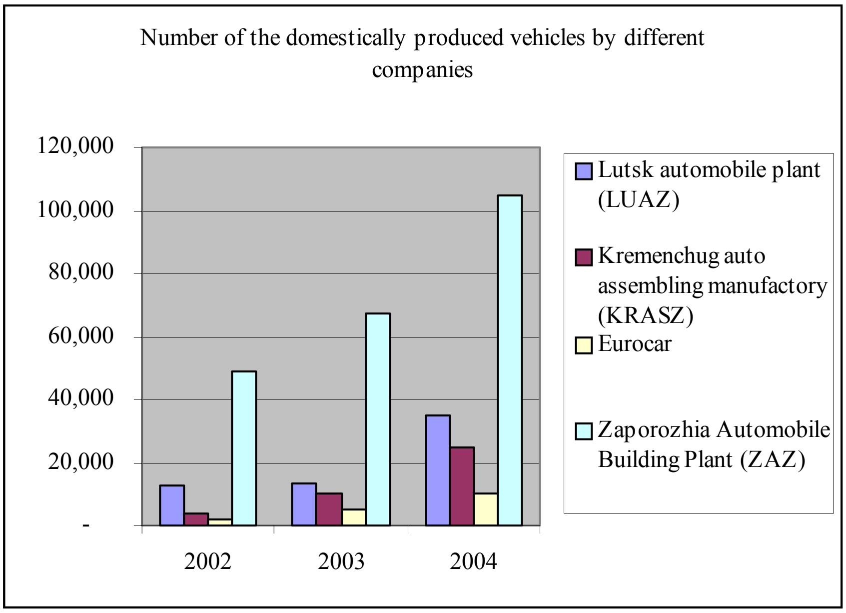
Name of the entity	**Fully domestic production**	**Assembling**
Kremenchug auto assembling manufactory (KRASZ)	0	100
Eurocar	0	100
Lutsk automobile plant (LUAZ)	1	99
Zaporozhia Automobile Building Plant (ZAZ)	76	24

Source: Ukrainian Ministry of Industrial Policy

Starting from 2002 all Ukrainian producers substantially increase the number of the produced cars. In our study we found, that this increase varies between two and six times. For example, during the last three years the Kremenchug auto assembling manufactory has expanded its production by more than six times, Eurocar by almost five times, and other two companies by more than two times. The leader in the

[9] Corporate site of ZAZ. For more details see www.avtozaz.com

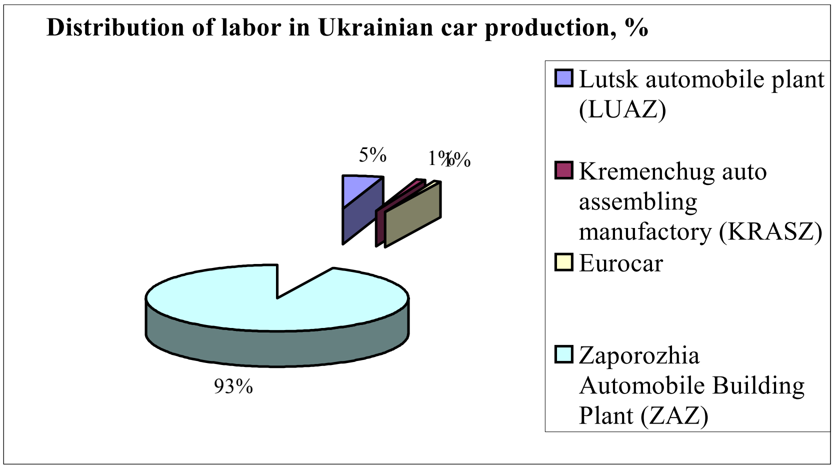
domestic production of cars is Zaporozhia Automobile Building Plant. It producers almost 60% of the domestically produced cars. The second largest producer is Lutsk Automobile Plant (20% of the domestically produced cars). Kremenchug auto assembling manufactory and Eurocar shares are 14% and 6% respectively.[10] See figure below.



Source: Ukrainian Ministry of Industrial Policy

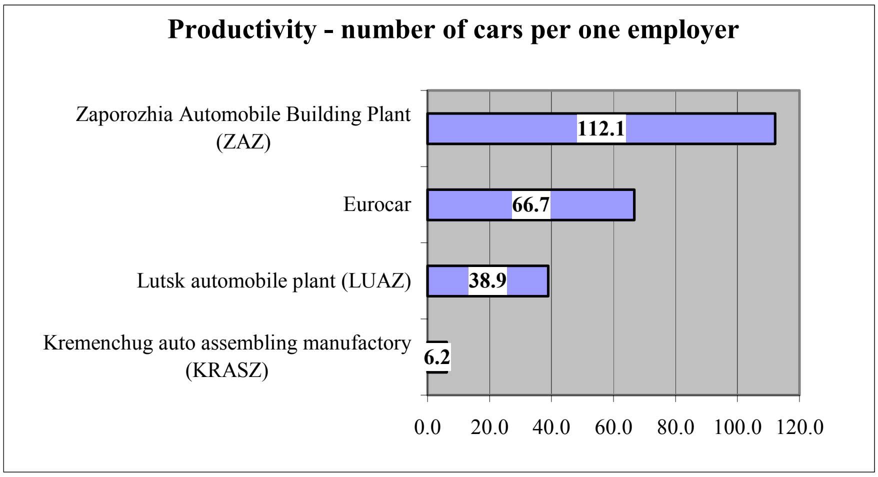
Obviously, since Zaporozhia Automobile Building Plant (ZAZ) is the biggest domestic producer of cars it is also the biggest employer in this industry. This company employs more than 16,000 people, which can be translated into 93% of all jobs in this industry. The second biggest producer Lutsk automobile plant (LUAZ) gives 5% of the jobs (see figure below). The shares of all other companies do not exceed 1%.

[10] Data of the Ukrainian Ministry of Industrial Policy



Source: Ukrainian Ministry of Industrial Policy, Ministry of Labour and Social Policy

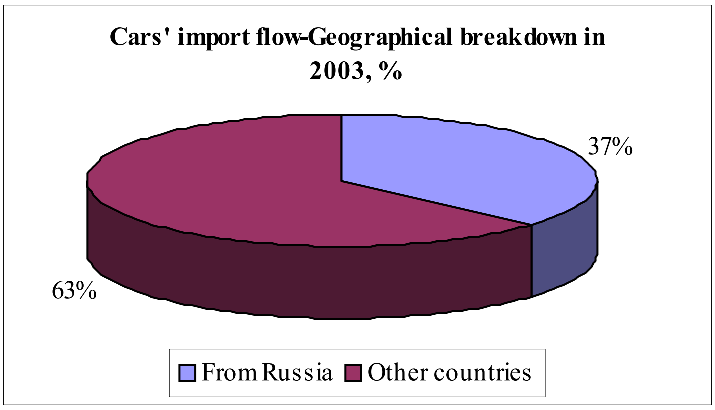
Our study indicated that the level of productivity in the Ukrainian car production varies from company to company but on average it still remains on a very low level. The highest level of productivity is shown by the Zaporozhia Automobile Building Plant (112.1 cars per one person). However, one employer at Kremenchug auto assembling manufactory is able to produce in 2004 only 6.2 cars. The existence of such differences in the level of productivity within the local producers of cars is due to two factors. First factor, the low level of the technical capacities of the existent in the industry facilities leads to the low level of productivity. Second factor, specific of the automobile industry, which reflects in the economy of scale. In other words, the higher the level of the existing facilities and production the more effect (productivity) can be reached.



Source: Ukrainian Ministry of Industrial Policy, Ministry of Labour and Social Policy, own calculations

2.2. Cars' import

Import of cars is an important component of the Ukrainian cars' market supply. In 2003, the number of the imported into the country first sale cars was around 90 thousand, which is only 6% less than domestically produced cars.[11] The geographical breakdown of the Ukrainian import of cars shows that 37% of it goes from Russia, which traditionally has high share on the local market. Such a big expansion of the Russian carmakers on the Ukrainian market is also stimulated by the government policy of having quotas for the Russian producers. Their import quota in 2003 was 15.8 thousand cars, which can be translated into 48% of the imported from Russia cars or into 17.6% of the all imported first sale cars to Ukraine.



Source: State Custom Committee

Import of the first sale cars to Ukraine, which goes from other than Russia countries, accounted to 57 thousand cars in 2003 or 63% of the all imported first sale cars. Almost 80% of the non-Russian origin import goes from the European states.[12]

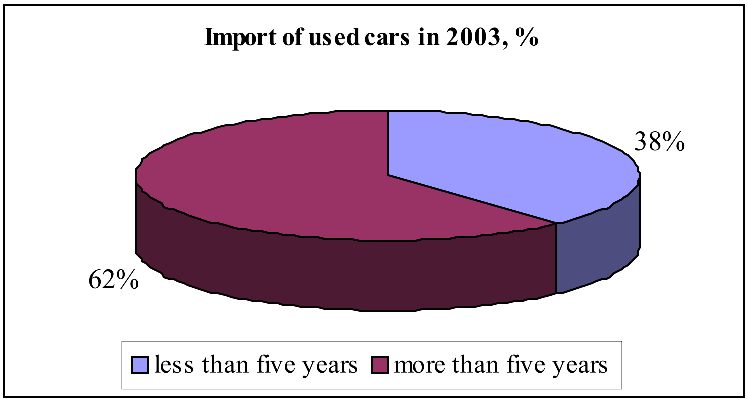
2.3. Domestic demand for cars

Domestic demand for cars has been constantly growing due to the increase in the incomes of populations. In 2003, income of the Ukrainian population increased by some 20% against the 2002 level. However, due to the limited amount of money which population is willing to spend for cars and due to the low technical standards required by them the import of used cars is a significant component of the domestic demand satisfaction.

In 2003 the number of imported used cars was 28.7 thousand, which is around 25% of the total amount of the imported into the country cars or 13% of the

[11] Data of the State Custom Committee
[12] Data of the State Custom Committee

domestically consumed cars (including domestic production of cars).[13] At the same time, by different estimation the shadow import of used cars can be on the same level as an official import of used cars, which brings the total volume of the car market in Ukraine to some 240 thousand cars a year.[14]



Source: State Custom Committee

Although it is difficult to judge about the technical quality of the existent in the country car stocks some estimation can be made. According to the State Automobile Inspection, from 5.6 million cars registered in Ukraine only 50% were able to pass a test from the state technical inspection. Other half is needed to be repaid and fixed in order to meet current safety and ecological requirements existing in the country.[15] Therefore, the potential size of the Ukrainian domestic market for cars can be significantly higher if the State Automobile Inspection makes tougher its requirements (meaning that only those cars, which meet the existing requirements can be used).

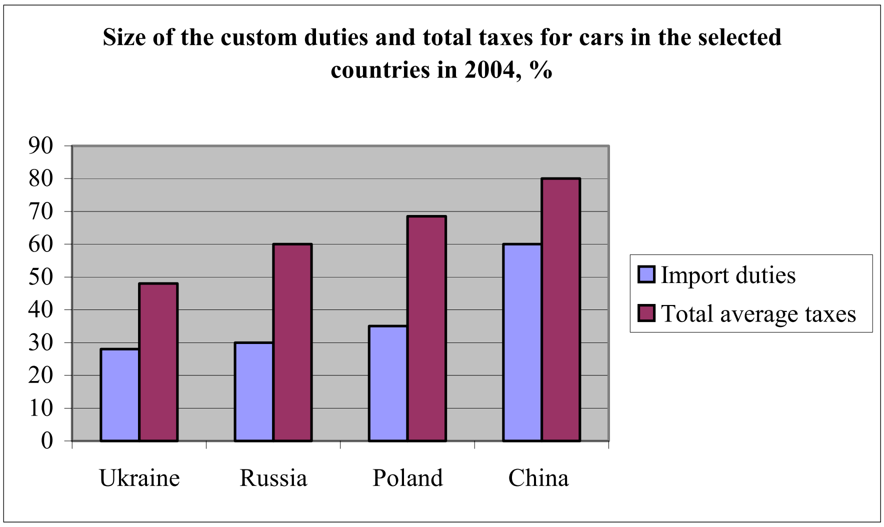
[13]Data of the State Custom Committee

[14] This amount includes domestically produced cars, imported first sale cars, and officially imported used cars and shadow import of used cars.

[15] Data of the State Automobile Inspection published at Business 34/23.08.04

3. Import regime for cars and support to local producers

Ukrainian import-export operations are subject to various taxes, including but not limited to: import duty, and value-added tax. The analysis shows that according to the existing legislation the average tax duty paid by importers of the new cars to Ukraine is amount to 15% of it invoice value. In addition to that a value-added tax (VAT) is levied at 20% and is also based on the customs value of the invoice amount. Therefore the total amount of taxes paid by importers of the first sale new cars accounts to 35% of its value. This is substantially lower than in many other countries (see figure below).



Source: Data of the individual countries' Customs Committees

Note: The existing in Poland import duty applies only for the non-EU-members' import

Simple calculations show that if the number of the non-Russian import of the first sale cars is 57,000 a year and the average invoice price of the car is USD 10,000 than the total annual amount of import of this group is USD 570 million. Amount paid by importers to the budget in a form of VAT and import duty equals to some USD 200 million per annum.[16]

The existent in the country system of the import regulation could be considered in line with other countries if it will not discriminate one producer compare with others. However, the feature of the Ukrainian import regulations in the

[16] Based on the existing VAT=20% and average import duty = 28%.

car market creates unfair competition. Although non-Russian importers make a substantial contribution to the country's budget, other importers do not do so. This is due to the existing in the country system of the privileges, which is part of the recently adopted Ukrainian presidential Decree On amendments to the Decree of the President of Ukraine of 10 June 1997, No.503, of 28 May 2004 No.589/2004.

The existent in the country legislation provides a certain peculiarities of the taxation of the income of automobile enterprises, which have investment programs approved by the Cabinet of Ministers of Ukraine until 1 January 2004. Privileges are differentiated among local producers of cars depending on the size of the investment made in Ukraine in automobile industry production facilities. If the company produces passenger cars it will be available to receive a special treatment regime if the amount of the investment is not less than USD 150 million. [17]

According to the newly adopted act import duty is not levied on goods and component parts used by the "Zaporizhya automobile plant" (CJSC "ZAZ"). The preferential treatment of this company means that cars produced in this company will be exempted from the import duty as well as from the VAT. The company obtained these privileges in September 1997. Since that time, the JV "AutoZAZ-Daewoo" (now — CJSC "ZAZ") has not presented a single new modern model of a Ukrainian vehicle, and only full-scale production of two models — "Tavriya" and "Slavuta" — is being carried out. The large unit installation of foreign automobiles is being carried out at this plant.

Our calculations shows that if in 2003 the number of the produced cars at Zaporozhia Automobile Building Plant was equal to 67 thousand with a minimum price of USD3,500 the minimum loss for budget were around USD 47 million. This figure captures only loss in the VAT revenue item. However, if we adjust it by the loss in the corporate tax it can rise up to USD 53 million.[18] Additional loss of the privileges in import duty for parts used in the production can increase this number to a minimum of USD 60 million.

The Russian transport producers VAZ, GAZ and UAZ also enjoy preferences in Ukraine. According to the provisions of the Agreement between the Government of Ukraine and the Government of the Russian Federation on Free Trade of 24 June

[17] Not less than USD 30 million — if trucks and buses are produced; not less than USD 10 million — if component parts to automobiles and buses are produced

[18] This calculation is based on the 12% level of profitability and 25% of the corporate income tax rate.

1993, special terms are implied for the import of goods in Ukraine on quota conditions. The minimum loss for the Ukrainian budget from having such a special treatment for the Russian cars can be accounted on the level of USD 22 million.[19]

Based on our analysis it can be concluded that Ukrainian budget suffers from the existing in the country preferential treatment regime for different importers and producers of cars. The minimum losses of such treatment costs around USD 82 million to the Ukrainian budget. This number is very good comparable with those USD 200 million, which budget obtains from the existing import in cars.

However, Ukrainian government's budget is not only one stakeholder, which suffers from the existing in the country preferential treatment. Ukrainian consumers of cars also lose. The existing system creates unfair competition. Domestic consumers should pay more for the low quality cars.

The existing of the high import duty has dual effect. On one side, it protects the existing in the country local car producers by increasing the importing prices and making the domestically produced cars' price more competitive. On the other side, the existing of such protection leads to ineffectiveness of the domestic production in a long run. In other words, although the domestic producers of cars win in a very short run, in a long run they lose. Free market and open competition can create for them a favourable environment, which is such needed for the future development of this industry.

19 This number is calculated based on the quota for Russian producers and the existing in Ukraine 20% VAT and 15% import duty.

Conclusions and recommendations

1. Ukrainian automobile industry is an important contributor to the country's GDP and labour market.

2. Future development of the Ukrainian automobile industry in a long run becomes impossible without bringing national legislation into line with the requirements of GATT/WTO and Partnership and Cooperation Agreement between Ukraine and the European Communities as well as their member states.

3. Domestic production of cars is concentrated in four main companies: Kremenchug auto assembling manufactory (KRASZ); Eurocar; Lutsk automobile plant (LUAZ); Zaporozhia Automobile Building Plant (ZAZ). With the only exception of Eurocar these companies has been traditionally specialized in the car manufacturing.

4. Mostly all domestic car producers simply import all the assembling parts. And then do assembling of their vehicles on a territory of Ukraine. Around 20% of the passenger vehicles were fully produced in Ukraine. The largest domestic producer in 2003 was Zaporozhia Automobile Building Plant (ZAZ). 76% of this company's output was fully produced in Ukraine.

5. The level of productivity in the Ukrainian car production varies from company to company but on average it still remains on a very low level.

6. Import of cars is an important component of the Ukrainian cars' market supply. In 2003, the number of the imported into the country first sale cars was around 90 thousand. 37% of it goes from Russia, which also has an import quota for cars.

7. Ukrainian import-export operations are subject to various taxes, including but not limited to: import duty, and value-added tax. The total amount of taxes paid by importers of the first sale new cars accounts to 35% of its value. This is substantially lower than in many other countries.

8. Amount paid by importers of the non-Russian origin cars to the Ukrainian budget in a form of VAT and import duty equals to USD 200 million per annum.

9. Ukrainian legislation creates a field for the unfair competition in the car market. Import duty is not levied on goods and component parts used by ZAZ. Minimum loss for budget from having this special treatment regime is equal to USD 60 million.

10. The Russian transport producers enjoy preferences in Ukraine. The minimum loss for the Ukrainian budget from having such a special treatment for the Russian producers of cars can be accounted on around USD 22 million.

11. Ukrainian consumers of cars lose due to the unfair competition. Currently they should pay more for the low quality cars.

12. Although the domestic producers of cars win in a very short run, in a long run they also lose due to decrease in the competition.

13. In order to stimulate development of the car sector additional measures from the side of the Ukrainian government shall be undertaken:

- all inequalities in treatment should be eliminated
- Ukrainian companies producing cars should be supported through the system of the special loans provision aimed to develop the technical level of the existing enterprises and increase their level of productivity to the international standards.