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Free Trade between Ukraine and the EU: An impact assessment

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List of abbreviations

ACAA	Agreement on Conformity Assessment and Acceptance of Industrial Products
AMC	Anti-Monopoly Committee
CE	Central Europe
CEN	European Committee on Standardization
CENELEC	European Committee on Electrotechnical Standardization
CEPS	Center for European Policy Studies
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
CSO	Civil society organization
CTHA	Chemical Tariff Harmonization Agreement
CTRCP	State Committee for Technical Regulation and Consumer Policy
EASA	European Aviation Safety Agency
EBRD	European Bank for Reconstruction and Development
EEA	European Economic Area
EFTA	European Free Trade Association
EIB	European Investment Bank
EMAS	Eco-Management and Audit Scheme
EMS	Environmental management system
ENP	European Neighborhood Policy
ENPI	European Neighborhood and Partnership Instrument
EU	European Union
EUROFER	European Confederation of Iron and Steel Industries
FAST	"Free and Secure Trade" program
FATF	Financial Action Task Force
FDI	Foreign direct investment
FEC	Fuel and electricity complex
FIG	Financial-industrial group
FTA	Free Trade Agreement
FTA+	Deep Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences
GDP	Gross domestic product
GPA	Government Procurement Agreement
GVA	Gross value-added
HES	Hydro-electric station
ICAO	International Civil Aviation Organization

ICPS	International Centre for Policy Studies
ICT	Information and communication technologies
IFI	International financial institution
IMF	International Monetary Fund
ISO	International Organization for Standardization
JAA	Joint Aviation Authority
JI	Joint Implementation
JSC	Joint stock company
MFN	Most-favored-nation status
MoU	Memorandum of Understanding
MTC	Ministry of Transport and Communication
NAFTA	North American Free Trade Agreement
NBU	National Bank of Ukraine
NERC	National Energy Regulatory Commission
NGO	Non-governmental organization
OEC	Unified Energy System
OECD	Organization for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
R&D	Research and development
REACH	EU system for registration, evaluation, authorization, and restriction of chemical substances
SBU	State Security Service
SDR	Special drawing rights (international currency)
SEZ	Special economic zone
SME	Small and medium enterprises
SPS	Agreement on the Application of Sanitary and Phyto-Sanitary Measures
TA	Technical assistance
TACIS	EU technical assistance program
TBT	Agreement on Technical Barriers to Trade
TC	Transport corridor
TCU	Tendering Chamber
TES	Thermo-electric station
TPD	Territory of priority development
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
UCTE	Union for the Coordination of Transmission of Electricity
UNESCO	United Nations Educational, Scientific and Cultural Organization
USSR	Union of Soviet Socialist Republics
VAT	Value-added tax
WCO	World Customs Organization
WTO	World Trade Organization

Overview

Deep free trade as a major element in a new agreement with the EU

Ukraine has already been granted market economy status from both the EU and the US. Yet, the reforms needed for the domestic market to operate effectively and integrate more deeply into the global economy remain incomplete. In Central European countries, the incentive for reforms was the prospect of membership in the European Union. So far, however, the EU is not ready to make a commitment to Ukraine.

In Spring 2008, the implementation period of the Partnership and Cooperation Agreement (PCA) between Ukraine and the European Union comes to an end and this agreement must be replaced by a new one. Even before the negotiations begin, the EU has indicated it is prepared to offer Ukraine an enhanced agreement. The EU is interested in expanding its influence in the region and to open access to new markets. This means that, even without officially recognized prospects for membership, Ukraine will gain access to the EU's Internal Market and opportunities for more active political cooperation and economic integration.

An important component of such an enhanced agreement is the section on free trade. The most widespread, classical form of free trade that involves the cancellation of export and import duties would not require significant institutional and legislative changes on Ukraine's part. However, it would also not have a serious positive impact in terms of an increase in trade between the two partners. Nor would it become the driver for integration with the EU.

Deep free trade, or FTA+, by contrast, in addition to the cancellation of customs duty, will call for liberalizing Ukraine's services sector and harmonizing its regulatory environment with EU standards. Although an enhanced version of the agreement will require significant financial and human resources, as well as institutional and legislative changes, it could realistically become the basis for a new economic strategy for the country and reinforce Ukraine's integration with the EU.¹

¹ For more on the possible consequences of deep free trade, see the Center for European Policy Studies paper called "The Prospects of Deep Free Trade Between the European Union and Ukraine." It includes a description of the possible format for this free trade agreement with the EU and models the impact of this agreement on both economies. Emerson et al (2006), CEPS, Brussels, http://shop.ceps.be/BookDetail.php?item_id=1321.

Adjusting to new standards and rules will cost Ukrainian producers in the short term. In the long term, however, it should help make domestic products more competitive and, as a result, increase Ukrainian exports to global markets. In addition, as the quality of Ukrainian products improves, it will strengthen the positions of domestic manufacturers on their own market. Meanwhile Ukrainian consumers will have access to higher quality and less costly goods and services. The Government's commitment to implement the reforms needed before signing a free trade agreement with the EU should raise confidence in the Ukrainian economy among foreign investors and spur both FDI and the country's integration into the global economy.

Opportunities during negotiation

The final format of the Free Trade Agreement and its provisions will depend on how the Ukrainian Government team negotiates with representatives of the European Commission—talks that are scheduled to begin in 2007. However, the opportunities and challenges of the negotiation process directly depend both on the capacity of the Ukrainian team to present a clear-cut position and on the specific interests that the European Commission represents.

Ukraine will have considerable freedom in negotiating with the EU, such as the option to choose the level of compliance of its legislation and standards, based on the readiness of a particular sector and its priority for the country's economic development. This means greater responsibility on the part of the Ukrainian team to clearly understand what reforms the country's economy needs, how economic and trade cooperation with the EU might be used to implement these reforms, and what consequences and limitations might be on the Ukrainian side. These include financial and human resources, the positions of interest groups, and so on. Indeed, the Government will have to work with specific interest groups to gain support and to prevent the formation of a hostile lobby.

Certainly, Ukrainian markets of goods and services cannot be completely opened to European Union companies immediately after the signing of this agreement, given that Ukrainian manufacturers are mostly not ready for serious outside competition. This is why the EU is ready to discuss transition periods for specific Ukrainian markets at the level of commodity groups, services, areas of business activity, and reforms to the regulatory environment—the last refers specifically to mechanisms for providing state aid—according to EU standards. Furthermore, to harmonize legislation, to adjust standards and norms, and to build the necessary institutions will all require external assistance. Given this, the EU has already promised to increase technical and financial assistance to Ukraine.

It will be impossible to completely avoid certain negative consequences of deep free trade with the EU, such as the closure of uncompetitive business-

es. However, ICPS economists are convinced that the cost of not instituting changes will be much higher for the country than any losses sustained by specific interest groups. Moreover, the Government can take steps that will help reduce the impact of negative consequences.

Goals and objectives of this study

This report was prepared as part of the "Support of Public Consultations on an EU – Ukraine Free Trade Agreement" project, implemented by a team of analysts from ICPS. The goal of the project is to help the Ukrainian Government prepare for negotiations on the EU – Ukraine Free Trade Agreement. The project results are this analysis of various implications of an EU – Ukraine Free Trade Agreement and the identification of the positions of interest groups through consultations.

By implementing a full public policy cycle, the Government can arm itself with the necessary arguments both for internal debate and for negotiations with the EU. Ukraine's experience with preparing for WTO accession can serve as an example of how the failure to follow public policy procedures significantly complicated the adoption of the necessary legislation in the Verkhovna Rada and resulted in the emergence of a powerful opposing lobby whose ideas are based on stereotypes, not on facts.

Together with economists from the Ministry of Economy, ICPS analysts selected sectoral issues that are likely to be included in the text of the Ukraine – EU Free Trade Agreement. For each issue, the analysts identified possible consequences of liberalization and adjusting the regulatory environment to EU norms and standards. The conclusions of this impact analysis were discussed with various stakeholders from the Government and private business during roundtables that were held from June to December 2006. Independent experts also participated in these discussions.

This report, which is based on the results of these debates, contains an analysis of the qualitative consequences of a Free Trade Agreement.² Among the general factors for evaluating impact, the authors used such criteria as improved rules for businesses, higher quality and more competitive goods, and more opportunities for Ukrainian companies to enter EU and other markets. The analysts then established a number of additional criteria for each specific sector, industry or issue.

Each section of this report analyzes the current situation and identifies problems in a specific sector or area of the economy. Most of these problems are

² Quantitative evaluation of the impact of liberalized trade in goods was not a component of this study, as the Ministry of Economy handles that type of analysis for FTA purposes.

not new but, so far, they have not been resolved, even when there appears to be political will. Two forces—the external pressure of the EU and the appeal of the EU's Internal Market—could provide the push that the Government needs to implement reform. In the absence of membership prospects for Ukraine, the EU's external pressure on Ukraine is likely to be much less effective. But the willingness of the Government to implement reforms in full can be increased through the support of Ukrainian business, as it would like to have access to EU markets.

The authors also analyze free trade agreements that the EU has signed with other countries—Chile, Croatia and Poland (when it was only a candidate for membership). Based on this analysis, they propose commitments that Ukraine and the EU might undertake as part of the FTA. For Ukraine, this mainly means steps to eliminate non-tariff barriers to trade and measures that will improve the quality of Ukrainian goods. For the EU, it means support for reforms in Ukraine.

New and important elements for Ukraine are the identification of stakeholders and the analysis of positive and negative impact, as well as opportunities and threats for each of these groups. The recommendations that are part of this report should allow the members of Ukraine's negotiating team to clearly understand sensitive issues for specific sectors and the positions of various stakeholders.

Executive summary

Part I. Trade in goods and services

The first section of this report is dedicated to trade and the improvement of the quality of goods and services in agriculture, the light, chemical and machine-building industries, the steel industry, energy, transport, and financial services.

TRADE FACILITATION. In addition to customs duties, the main barriers to trade in Ukrainian goods on EU markets are non-tariff restrictions, such as having to meet EU standards, differences in customs systems, and differing procedures for determining the compliance of industrial products. An additional barrier to Ukrainian goods are the preferential rules of origin of goods that are applied by the European Union.

As part of its negotiations on the Free Trade Agreement, Ukraine can commit to a number of measures aimed at eliminating these non-tariff barriers. Ukrainian standards can be gradually harmonized with common European standards and customs procedures can be simplified according to WTO rules, following EU practice. Technical assistance from counterparts in the New EU Member States that not so long ago underwent reorganization processes

would be useful for Ukrainian customs officials. Ukraine can also begin talks on participation in the Pan-Euro-Mediterranean Cumulation System, which would make it possible to use raw materials originating from all EU countries in manufacturing processes in Ukraine and to export finished products to the EU at zero import duty rates. Such steps would not only contribute to liberalizing trade between Ukraine and the EU, but would also help improve the business environment, increase FDI and improve the rules of business on the domestic market.

Manufacturers of industrial goods who will have to accept new, stricter standards are likely to offer the greatest resistance to these changes—especially those exporting mostly to CIS countries, where common standards have long been agreed. Resistance could emerge from bureaucrats wanting to preserve the status quo, such as the Customs Service regarding combating corruption, or politicians and officials concerned that the State Budget will lose revenues from export and import duties or spend more reforming the standardization system.

It is possible to find support for reforms among Ukrainian importers and exporters interested in the elimination of non-tariff barriers to trade. The Government can also use their experience and knowledge of EU standards to eliminate obstacles to trade at the domestic level. Possible economic losses from changes in manufacturing standards should be compensated by growing profits among exporters and importers of goods and services, with lower barriers to foreign trade and more effective operation of Ukraine's Customs Service. Cooperation with Ukrainian manufacturers on harmonizing standards will help the Government save money through the adjustment of the most important standards, rather than comprehensive harmonization.

Budget spending to harmonize the national system of standards could be partly compensated through financial and technical assistance from the EU. After the process of harmonization is completed, opportunities to export Ukrainian goods, not only to the EU, but also to third countries, will grow significantly. Simplifying customs procedures will require spending to re-equip the Customs Service and re-train specialists. On the other hand, computerizing the Customs Service should help combat corruption, lower expenditures by reducing Customs staff, and contribute to increased foreign trade.

AGRICULTURAL PRODUCTS. As a rule, the majority of agricultural products are excluded from free trade agreements with the European Union. As part of trade between Ukraine and the EU, it can be predicted that the Agreement will cover only a few products.

Cereals will continue to be the main type of agricultural products exported from Ukraine to the EU. That makes it important for Ukraine to establish a free trade regime for these goods. Most likely, sugar will be excluded from

the Agreement, given the high degree of protectionism in this sector on both sides. Exports of animal products from Ukraine to the EU will be restricted, because Ukrainian products do not meet standards. Ukraine could negotiate a schedule for a gradual opening of the EU market, as the country raises its standards to EU levels. A free trade regime will also help develop fruit and vegetable growing in Ukraine. Initially, these sub-sectors will require state support to level out the negative consequences of growing competition.

Deep free trade with the EU could contribute to achieving such goals as increasing the competitiveness of Ukraine's agricultural products through harmonizing health and public interest standards with EU standards.

Clearly, agriculture must be included in the Agreement, with consideration for measures that will help improve the quality of goods by harmonizing Ukrainian sanitary and phyto-sanitary standards with EU ones. The country also needs to set up a proper infrastructure, such as laboratories, to support an effective system for checking the quality of agricultural products. This can be done through non-trade forms of cooperation, that is, through instituting programs for training Ukrainian growers and breeders, facilitating investment from the EU, and introducing cutting-edge technologies and farm equipment and machinery in Ukraine.

Producers of agricultural products could prove skeptical about the need to adjust to new standards. A public awareness campaign promoting the positive consequences, such as the opportunity to enter EU markets in the future and an improved business climate, is key to preventing the entrenchment of a negative attitude towards the FTA and future reforms. The greatest resistance to reforming the system of food quality and safety regulation is likely to come from government officials themselves in those agencies responsible for agricultural regulation, as their arbitrary powers would be curtailed with the coming of a more effective system.

INDUSTRY. Currently, the majority of industrial sectors are showing positive growth trends, largely driven by a favorable situation on external markets. However, dependence on external demand for raw materials cannot serve as a basis for an economic development strategy because prices on global commodity markets are too volatile. The growth of trade in manufacturing industries, such as the machine-building, light and chemical industries, is complicated due to the failure of these products to meet technical and other standards, an unfavorable investment climate, and ineffective border-crossing system.

Deep free trade with the EU will help expand industrial output, as it requires unifying standards for industrial products. The transition to optional standardization should not cause much resistance among manufacturers in these sectors. But some changes, such as measures to take the manufacture and sale

of products from the light industry out of the shadow economy or to commercialize inventions—specifically in energy-saving—in the chemical industry, could displease specific interest groups. The process of restructuring industry could be made less painful by attracting foreign investment to modernize and establish new enterprises and sectors.

State aid could prove a problematic issue in the negotiating process, especially given the position of interest groups in the machine-building sector. These groups are asking for lengthy transition periods to liberalize trade, if the Government stops providing sector-specific support. New FDI could compensate for these losses, but it requires a better business environment and measures to help Ukrainian enterprises join EU production and supply chains.

THE STEEL INDUSTRY. Steel products constitute one of the most important groups of commodities exported by Ukraine, especially to the EU. The steel lobby is a powerful group whose interests are represented in the Verkhovna Rada. Sector's biggest problems are obsolete plants and the low quality and low added value of the products being made. Moreover, steel products are restricted by non-tariff barriers, such as distorted competition due to state support. An unfavorable investment climate, underdeveloped financial services market, and poor environmental regulation constitute additional obstacles to trade.

In the context of a Deep Free Trade Agreement, these barriers and restrictions could be eliminated by harmonizing technical standards and bringing the regulatory environment in line with EU norms and standards.

Currently, some elements in Ukraine's steel industry, such as iron ore producers and traders in scrap metal, are demonstrating the most positive attitude towards integration into EU and global markets. They understand that accession to the WTO will stop restrictive quotas on trade in steel products. Harmonized standards and regulations as part of this Free Trade Agreement will help avoid—or at least reduce—trade restrictions and expand Ukrainian steel products on EU markets.

Still, Ukrainian steelmakers could find themselves suffering parallel negative consequences like declining subsidies in the fuel and energy complex and rising production costs, as raw materials become more costly and stricter environmental regulations kick in.

THE ENERGY SECTOR. Even after the cancellation of tariffs for trade in energy, Ukrainian power utilities will not have enough opportunity to export electricity to the EU because of their underdeveloped marketing infrastructure and differences between the technical standards and rules that govern the energy markets of the EU and Ukraine. The EU may also leave the restrictions on imports of Ukrainian coal and petroleum products in place because of continuing subsidies to domestic producers. This means that the development of

the energy sector as part of the Deep Free Trade Agreement is seen primarily through building cross-border electricity sales and eventually forming a common energy market with the EU.

Restrictions could be eliminated by harmonizing the electricity market regulatory environment with EU rules, linking power grids, and promoting nuclear safety. Reforming the energy sector by dropping the practice of cross-subsidizing rates for residential consumers, increasing the institutional capacity of the National Energy Regulatory Commission (NERC) to regulate independently, and building the infrastructure of links to ensure technical compatibility with EU power grids should make it possible to increase efficiency and competitiveness in this sector.

Ukrainian producers and exporters of electricity will be the most interested in this reform coming into play through the Agreement because the positive consequence—access to the EU markets—will outweigh the negative one—the cost of modernization. Residential and industrial consumers alike are bound to oppose reforms because power rates will go up. Through public awareness campaigns, though, it should be possible to avoid the emergence of a strong lobby against reforms in the energy sector, since all consumers will get better quality services, while industrial consumers will be able to choose a supplier.

TRANSPORT. Despite the liberalization that will take place once Ukraine accedes to the WTO, important segments of the transport sector are not covered by the WTO and the General Agreement on Trade in Services. Problems that hamper free and effective movement of goods and people are inefficient infrastructure due to depreciated assets and monopolization in some market segments.

Cooperation between Ukraine and the EU must aim at physical infrastructure support for the operation of a free trade area and the gradual formation of a common market of transport services between Ukraine and the EU. The urgent objectives for Ukraine are: (1) to hold negotiations on an “open skies” policy with full accession to the EU’s Common Aviation Area; (2) to facilitate the development of the main land transport corridors (TCs); and (3) to eliminate barriers to border crossing, primarily by reforming customs controls. The domestic market needs to be opened up to top European operators and the regulatory environment needs to be harmonized.

These measures should lead to an increase in foreign trade opportunities for Ukrainian businesses and increased Budget revenues as transportation expands. Still, commuters and business will get higher quality services even as the cost of using upgraded transport infrastructure rises.

Overall, transport market players engaged in international carriage support free trade, because they currently run into barriers to access to the Europe-

an markets. However, they could oppose to rapid liberalization if it begins to edge them out of the market. The Government can initiate the restructuring of key sectors to improve their readiness for stronger competition. The role of the Government is critical in transforming the transport sector, as the overwhelming majority of market participants are state-owned enterprises or institutions that need reform, such as the Customs Service.

FINANCIAL SERVICES. The financial services markets are developing at a rapid pace. The growing capital and assets of the banking system and the increased volumes traded on the stock market are evidence of qualitative and quantitative improvements in the sector. Still, a number of issues related to corporate governance, oversight and supervision standards, transparency, and procedures for combating money-laundering raise risks for financial institutions. They could also become obstacles to free trade in such services between Ukraine and the European Union.

As part of the Free Trade Agreement, it should be possible to plan a number of regulatory changes that will make it possible to resolve these problems. This should improve the sustainability and stability of the financial services market. It should also facilitate access to cheaper and longer-term resources for Ukrainian financial institutions and lay the foundation for their entry into EU financial services markets in the long term.

A number of financial-industrial groups (FIGs) are likely to oppose the liberalization of financial services with the EU, because of the threat of growing competition on the market and the risk of losing control over their businesses as they are obliged to become more transparent. Still, the majority of FIGs are interested in increasing the value of their enterprises and in having the opportunity to eventually sell them to foreign investors for a profit. In this sense, the liberalization of financial services with the EU could be very lucrative for owners of financial companies. It should also tangibly increase their capital, provided that appropriate business development strategies are established in the process of instituting free trade.

Part II. Cross-cutting issues

The second part of this report covers cross-cutting issues: the investment climate, state aid, the public procurements system, migration, and the environment. Their problems are related to many sectors of the economy and their solution will have positive consequences for the economy as a whole. It should also help improve rules of the game for both domestic and foreign businesses.

THE INVESTMENT CLIMATE. Foreign capital inflows to Ukraine, especially FDI flows, are currently growing very fast. Serious investment is being channeled into the banking sector, the steel industry, real estate, retail trade, and other areas. Still, a number of issues related to investors' rights, proper establish-

ment of ownership, and corporate governance significantly hamper investment among both foreign and domestic investors.

A Free Trade Agreement with the EU must include measures to make Ukrainian legislation more transparent and systematized, like EU legislation. This will make it possible to eliminate obstacles to investment activity, especially in terms of corporate governance, taxation and the free movement of capital between Ukraine and the EU. This should increase the size and improve the quality of capital channeled into Ukraine from abroad, as well as simplify procedures for Ukrainian businesses to enter the EU markets.

Certain large corporations could oppose more transparent rules of the game because of the perceived risk of losing control over their businesses. Still, the overall improvement of the country's investment climate that should result from the proposed changes will make the Ukrainian market more attractive and, thus, raise value of domestic business and their owners' capital.

STATE AID. State aid is one of the most urgent and most contradictory issues that is likely to arise during negotiations with the European Union. Sectoral and, in some instances, regional forms of state aid for businesses distort the conditions for trade. This encourages Ukraine's trading partners to launch anti-dumping probes and introduce quotas on specific imports. Recent cases when the EU accused Ukrainian pipe manufacturers of dumping were justified because of energy subsidies and demonstrate the importance of reforming state aid in the country.

A priority for the Ukrainian side is to harmonize the national legislation on state aid with EU requirements in order to ensure a gradual transition from financial support for specific companies and sectors to regional and horizontal support. It will be necessary to establish new or upgrade existing institutions and rules that meet EU standards and, in the distant future, to try to coordinate competition policies.

The overwhelming majority of businesses that participated in our debates said they were ready for markets of goods and services to be liberalized. But many of them were not prepared to give up state aid that, in their opinion, was the only instrument to protect them against foreign competition. Those businesses that were ready to give up state aid insisted on a long transition period that they expected the Ukrainian Government to bargain for during FTA negotiations.

A reformed state aid system should make it possible to regulate the problems of access to EU markets for Ukrainian goods and companies. Underdeveloped regions will continue to receive support even within SEZs/TPDs. Enterprises engaged in R&D and environmental protection will have a chance to benefit due to changes in state aid priorities.

PUBLIC PROCUREMENTS. Public procurements are one of the most corrupt spheres in Ukraine. The rules and principles for the way procurements operate are anything but transparent. There are numerous technical and bureaucratic barriers to participate in tenders, which end up costing extra time and money for those who want to bid. Recent changes in domestic legislation made this sphere even less transparent, compared to EU standards. The Free Trade Agreement must include provisions on public procurements.³ The reform of the public procurements system could contribute to more efficient distribution of resources once the rules become transparent. This, in turn, will lead to greater competition and higher quality procurements, saving Ukrainian taxpayers considerable sums.

Harmonizing Ukrainian legislation to EU standards and rules will make it possible to institute transparent principles and rules for the operation of public procurements, to foster the protection of the rights of those who participate in tenders, and to reduce time and material costs related to such tenders. This should also curtail the abuse of power by functionaries, which most businesses say would be a positive development.

Still, there is bound to be opposition to reforms on the part of certain functionaries who skim illegal profits in the current opaque system. Transparency in public procurements will depend on institutions regulating their operation. The increased funding needed to build such institutions could lead to dissatisfaction among Government officials who are concerned about the State Budget. However, Ukraine should be able to draw on EU funds and practical assistance, through instruments like the Twinning projects. This will make it possible to reduce the burden on Ukrainian taxpayers.

Growing competition as public procurements become liberalized raises concerns among large and medium enterprises. However, there will be no significant changes to competition conditions. Western companies already participate in large-scale tenders, while the value of small-scale objects is not high enough to attract foreigners. Still, the Government must increase its efforts to establish compliance between Ukrainian and European quality certificates. This will seriously ease access to EU markets for Ukrainian producers—and not only in public procurements.

MIGRATION. The ability of Ukrainian nationals to move into the European Union is extremely limited due to barriers in the form of work permit requirements and the common EU visa policy. Based on the current PCA, the principle of non-discrimination on the basis of nationality is supposed to apply to

³ The immediate liberalization of public procurements should lead to more competition. Ukrainian companies are not prepared for this and will need time to adjust to new conditions. The passage of a new edition of the law on public procurements and building relevant institutions will need about three years. This makes it important to bring related legislation in line with WTO and EU standards before the start of negotiations on free trade with the EU.

Ukrainian nationals legally working in the EU. However, they do not have access to social benefits because there is no mechanism for coordinating social security systems between Ukraine and the EU. The principles of non-discrimination and access to social benefits also do not apply to the family members of such legal migrant workers. Finally, Ukrainian nationals are mainly stuck in unskilled jobs because their academic degrees and qualifications are not recognized in the EU.

Implementing a new agreement between Ukraine and the EU will not fully ensure free movement of Ukrainian nationals on EU territory. However, this Agreement could establish better conditions for those who are already working in the EU and members of their families. At the political level, this will have positive consequences as support for Ukraine's integration into the EU.

Coordinating social security systems will ease access for Ukrainian workers to social security benefits both while they work in the EU and after they return to Ukraine. Cooperation beyond the limits of the Bologna process and the necessary adjustments to Ukrainian legislation on education for mutual recognition of academic degrees and qualifications will make it possible for Ukrainian workers to seek foreign jobs requiring more skills. Continuing negotiations with the EU on the institution of a visa-free regime for all Ukrainian nationals will be an additional step towards ensuring free the movement of people between Ukraine and the EU. Even partial facilitation of migration between Ukraine and the EU could contribute to additional investment, less social inequality, new jobs, growing educational potential, and higher social standards.

Still, steps to facilitate access for Ukrainians to the EU labor market could also lead to greater migration from Ukraine, a deeper brain-drain, and even a shortage of labor in certain sectors. To avoid such negative consequences, the Government needs to establish the conditions for migrants to return and invest their knowledge, experience and earnings into their own country's economy. Reforms that improve the business climate in Ukraine, a more favorable environment for SMEs, and a reduction in the level of corruption must be priorities in order to keep Ukrainians in their homeland.

THE ENVIRONMENT. Ukraine's environmental policy is ineffective. The current system of environmental standards and rules, oversight, monitoring, incentives, and penalties has done little to reduce the amount of damage to the environment due to commercial activity or to increase the safe management of nature. The failure of Ukrainian technologies and products to meet EU environmental standards is a significant barrier in the way of Ukrainian goods to access EU markets.

The Free Trade Agreement with the EU should include a section on cooperation in the environment. This should exert external pressure and provide

incentive for reforming domestic environmental policy. The EU's position on this section within the FTA will be determined by the conclusions of a current European Commission study on its impact on sustainable development.

Ukraine needs to identify its own interests, evaluate its capacities and environmental policy goals, and study the options for cooperating with the EU. Cooperation priorities for Ukraine could include greater institutional capacity in the Government in environmental policy, harmonizing the domestic environmental standards system, and developing environmental management systems (EMS) and a system for trading in waste. The advantage for Ukraine is freedom to choose the level of compliance with EU standards and norms and the pace of harmonization based on the country's own needs and capacities.

Reforming environmental policy will allow Ukraine to gradually reduce the proportion of energy and resource consumption in the country's GDP, to develop a market of eco-friendly goods, technologies and services, to use harmonized standards to ensure access to the EU markets for Ukrainian goods and restrict access of undesirable goods to Ukraine, to obtain and effectively use capital from selling waste, and to contribute to improving quality of life.

Institutional development in environmental protection and the establishment of new standards and procedures will require additional public spending. This can be compensated through financial and technical assistance from the EU. Still, as Ukrainian businesses find themselves having to spend more in order to meet new standards, especially re-equipment costs and environmental charges, they could put up considerable resistance.

Recommendations to the Government: How to negotiate and minimize negative consequences

- Develop a clear-cut list of issues that must be resolved and prospects for Ukraine's economy.
- Clearly understand how different interest groups will be affected by this Agreement and their various positions.
- Work with these interest groups through consultations and keep them informed of the Government's position on each provision of the FTA (for example, joint working groups headed by the Ministry of Economy).
- Study international practice in setting up free trade areas using the example of agreements between the EU and Poland, Chile and Croatia (the specifics of the negotiation process, appendices to the agreements and so on).

- Identify the needed/desired level of compliance with the EU *acquis* with regard to domestic legislation in each area or sector, proceeding from reform objectives.
- Do a quantitative analysis of the consequences of this Agreement for each area or sector and the economy as a whole, trying to anticipate unforeseen effects that might appear during the implementation of the FTA (for example, establishing new institutions, training civil servants and organizing lobbying campaigns for business).

Part I

Trade in goods and services



Trade facilitation

Customs duties that push up prices for goods are not the only burden facing international trade. Non-tariff barriers play a very important role: they significantly raise transport, logistical, administrative, and time costs for businesses and sometimes even make it impossible to enter a market at all.

With accession to the WTO, some barriers to trade between Ukraine and the EU will be eliminated. At the same time, there still will be many issues whose solution will require serious financial resources, skills and time. The Agreement on an FTA+ between Ukraine and the European Union differs from a simple free trade agreement precisely because of the attention it pays to eliminating non-tariff barriers. The main emphasis should be on four key areas of cooperation:

- *canceling exceptions and restrictions, while simultaneous providing certain Ukrainian sectors with a transition period;*
- *harmonizing Ukrainian standards with European ones;*
- *optimizing customs procedures;*
- *coordinating rules of origins of goods.*

Work in these areas will require significant efforts and financial resources from the Ukrainian Government and domestic companies. However, potential benefits in terms of competitive advantage for domestic producers and improvement in well-being of Ukrainian consumers are very high. This means that, when negotiating an FTA+, the Government and other stakeholders must make the maximum efforts to use this potential and to minimize negative consequences.

Global practice in trade facilitation

Trade facilitation is a comprehensive and integrated way to simplify international trade and make it less costly. The goal of trade facilitation is to reduce costs related to the international production chain, especially direct costs when goods cross borders. Nowadays, the main obstacles to international trade flows are requirements that importers and exporters submit numerous documents and that they are subject to unjustifiably complicated border-crossing procedures. As customs duties gradually shrink, there is a growing concern that import and export procedures could soon become almost insuperable non-tariff barriers.

Trade facilitation is directly related to two problems. The first one is numerous customs systems and procedures; the second one is onerous regulatory and documentation requirements. Both problems constitute tangible obstacles to the cross-border movement of goods. As a result of this, there are additional costs and delays for exporters and importers, especially in developing countries where customs procedures are the least computerised.

Benefits of trade facilitation

1. Growing transparency and predictability:
 - a tangible reduction in administrative costs for foreign trade operators;
 - minimized mistakes by customs officers and fewer opportunities for corruption;
 - growing FDI;
 - overall greater efficiency in export and import sectors.
2. More rapid customs clearance reduces:
 - problems with storing goods in warehouses;
 - the risk of deteriorating quality of goods;
 - the risk of theft;
 - the number of deferred payments;
 - the risk of loss of interest in international trade with capital tied up in goods.
3. Improved efficiency and security:
 - transparency and simplified customs clearance limits opportunities for criminal activity;
 - resources earlier tied up in red tape can be used to combat crime.

Source: SWERPO (2002), Trade Facilitation—Impact and Potential Gains, www.kommers.se/documents_show.asp?id=44.

Estimates show that the cost of trade procedures constitutes 4–5% of the total value of trade, which is about equal to the current average import duty rate for

industrial goods in industrial counties—3.8%.⁴ At the same time, some studies revealed that trade facilitation had potential benefits for all countries. This is particularly true of developing countries, where higher effectiveness and efficiency at customs houses increases the opportunities to attract foreign investment.

Trade facilitation in Free Trade Agreements between the EU and developing countries⁵

Trade facilitation in the broad sense has not received much attention in some of the free trade agreements (FTAs) recently concluded by the EU. In the majority of these agreements, trade facilitation is mentioned only in the context of cooperation among customs houses, which “must ensure fair trade and observance of trade rules.” This means that, in terms of depth and special measures, sections of FTAs dedicated to trade facilitation tend to be superficial, although they are frequently accompanied by detailed Protocols describing how the customs administrations of the sides should provide mutual assistance.

But there are two exceptions—FTAs with Chile and Mexico—that contain considerable detail related to measures to facilitate trade that are mandatory for both sides. EU requirements for trade facilitation depend on the current degree of trade liberalization in the given partner country, and also the willingness and capacity of that country to implement specific measures to facilitate trade. For example, a part of the FTA Agreement with Chile that contains terms and conditions for facilitating trade is broader and more detailed than bilateral agreements on a free trade area with Mediterranean countries. The agreements with **Mediterranean countries**⁶ provide for:

- simplifying the procedure for customs clearance of goods. Computerization of customs procedures is included only in the agreement with Israel;
- instituting a single administrative document, the same as the counterpart EU document (except for agreements with Israel and Lebanon);
- providing the possibility of connections between the transit systems of the EU and partner countries (except for Israel);
- exchanging information among experts, organizing field workshops and seminars, and providing technical assistance, if necessary.

All the agreements with Mediterranean countries contain a separate Protocol on the procedure for ensuring “mutual assistance” for the administrations of

⁴ The European Commission, Trade Issues, http://europa.eu.int/comm/trade/issues/sectoral/facilitation/index_en.htm.

⁵ According to materials of the European Centre for Development Policy Management (ECDPM).

⁶ So far, the EU has signed bilateral Association Agreements with seven Mediterranean countries: Tunisia (1995), Israel (1995), Morocco (1996), Jordan (1997), the Palestinian Autonomy (1997), Algeria (2001), and Lebanon (2002).

the contracting parties. These protocols do not contain specific steps to facilitate trade. Rather, they describe the nature of the assistance that one contracting party can request from the other. These agreements also place obligations on the parties to provide such assistance "within the limits of their competence and available resources." However, there are exceptions to the obligation to provide assistance, if such assistance:

- could damage the sovereignty of one of the contracting parties;
- could damage public policy, security or other important interest;
- is related to foreign currency or tax regulations that are different from those regulating customs taxes;
- breaches industrial, commercial or professional secrets.

The Global Agreement between the EU and **Mexico** that was signed in December 1997 and came into force in October 2000 contains more in-depth steps to facilitate trade than other EU FTAs. The importance of facilitating trade for both the EU and Mexico and the desire of the two sides to consider trade facilitation in greater depth are evident in the presence of a Special Committee on Customs Cooperation that has been mandated to focus on all issues related to customs and to expand cooperation in developing, applying and accelerating customs procedures.

Table 1. Trade facilitation in free trade agreements with the EU

	Euro-Mediterranean Association Agreements	The Agreement on Trade, Development and Cooperation between the EU and the SAR	The Global Agreement between the EU and Mexico	The Association Agreement between the EU and Chile
Technical assistance and information exchange	☑	☑	☑	☑
Standardization and simplification of customs procedures:				
• The institution of a single administrative document	☑ ^a		☑	☑
• A "one-stop shop" and the establishment of a single customs body				☑
• Computerization and automation of customs procedures	☑ ^b		c	☑
Risk management, pre-border crossing procedures and post-crossing audits			c	☑
Court and administrative steps related to customs			c	☑

a – except for Lebanon and Israel; b – only for Israel; c – limits were not identified, but the Special Committee on Customs Cooperation can propose any measures to improve activities and the effectiveness of operations.

The EU – **Chile** FTA signed in November 2002 is the most progressive agreement in terms of its depth and the steps aimed at facilitating bilateral trade

among all bilateral agreements on setting up an FTA signed by the EU until now. The agreement with Chile contains the majority of the positions on trade facilitation that the EU takes in negotiations on global trade facilitation at the WTO. The EU thinks that inadequate level of cooperation among customs houses and other Government bodies leads to a situation where goods are repeatedly inspected in different places. So, among other things, the countries commit themselves to:

- simplifying requirements and formalities related to customs clearance of goods and improving the transparency and efficiency of customs operations;
- developing procedures that would make it possible to collect export and import data in a single body—reducing, simplifying and standardizing information that needs to be included in customs documents and ensuring the use of a single incoming and outgoing document according to international standards;
- ensuring coordination of customs and other oversight bodies to make it possible for this data-collecting body to exercise official control over exports and imports.

Measures listed in the Free Trade Agreement between the EU and Chile that are absent in other EU FTAs include:

- computerization of customs procedures and possible institution of common standards;
- the application of modern customs technologies, including risk management, simplified procedures for importing and selling goods, after-sale oversight, and ways of auditing companies;
- the institution of a common position in international organizations that examine customs issues—the WTO and the World Customs Organization (WCO).

As for court and administrative steps, the parties commit themselves to ensuring efficient and clear-cut procedures that will make it possible to challenge the actions, rules and decisions of the customs house or some other body that has influence on imports or exports of goods. The parties also agreed that their mutual trade and customs resolutions and procedures must be based, among other things, on the rule that punishments for the violation of customs rules or procedures will not result in a significant delay in the actual process of a customs inspection.

The agreement also provides for expanding cooperation between customs bodies and business entities: the countries commit themselves to instituting mechanisms for consultations between administrations and commercial agents, to make information on working hours and contact details of customs bodies public and accessible in order to clarify information and to get expla-

nations on unclear issues. All changes must be published no later than when they come into force.

The agreement introduces a Special Committee on Customs Cooperation and the Rules of Origin of Goods. Its goal, among other things, is to oversee the issues related to mutual access to markets.

The EU – Chile FTA reflects the extraordinary importance the parties give to the issue of trade facilitation. As for Chile, the depth of the agreement is the evidence of the readiness for further liberalization and economic reform, as it commits this developing country to implementing large-scale reforms and modernization. In fact, Chile is already a good example of broad liberalization of trade and investment. Little wonder that Chile agreed to serious commitments in setting up a free trade area with the EU, which will help secure internal economic and institutional reforms as well.

Clearly, the 10 FTA agreements between the EU and developing countries have different degrees of depth and scale. As a rule, countries with less developed trade institutions and/or less liberal trade and economic regimes undertake less detailed commitments to facilitate trade, while countries whose trade institutions are more developed and/or who have already begun large-scale trade and economic reforms agree to deeper terms and conditions. Thus, the depth of an FTA agreement with the EU depends both on the country's willingness and its capacity to fulfill the commitments that it undertakes. The former is connected to economic culture and concepts, while the latter is connected to institutional capacity to implement measures that may require technical knowledge and significant costs. The more energetically a developing country undertakes the commitment to liberalize its economic policy and implement institutional reforms, the more it must try to undertake international commitments to deepen these reforms. The fact that the latest EU FTAs, with Mexico and Chile, are more detailed regarding trade facilitation issues is further evidence of the overall global trend towards simplifying trade and customs procedures.

As for the EU, it has always been one of the main supporters of trade facilitation within the WTO. The EU's position is simple: exponential growth of global trade must be accompanied by powerful, effective steps to simplify trade procedures. However, the EU also understands the need for a special approach to developing countries. Specifically, the Union proposed asymmetric agreements that allow for differences in commitments and longer transition periods for these countries. For example, the EU proposed that commitments to facilitate trade should not kick in before developing countries are capable of fulfilling them. In other words, the EU did not allow Mediterranean countries to take on FTA commitments to institute all possible measures to facilitate trade simply on the basis of their desire to do so.

Trade facilitation in current Ukraine–EU relations

The actual contractual base

The bilateral relations between Ukraine and the European Union are based on provisions of the Partnership and Cooperation Agreement (PCA) that was signed in 1994 and came into force in 1998 for a 10-year period. The future Free Trade Agreement between Ukraine and the EU could become part of a new agreement that will replace the Partnership and Cooperation Agreement after 2008.

Other significant bilateral agreements between Ukraine and the EU involve trade in textiles and clothing, which is currently completely liberalized, trade in steel products, and cooperation in controlled nuclear fusion. Ukrainian exports of many types of steel products to the EU are restricted by a system of quotas that will become null and void after Ukraine's accession to the WTO.

As part of the Partnership and Cooperation Agreement, Ukraine and the EU hold regular consultations on expanding trade volumes. According to the PCA, trade facilitation between Ukraine and the EU covers three main areas:

- the reduction of technical barriers to trade (Ukraine's accession to the Agreement on Technical Barriers to Trade (TBT/WTO));
- mutual recognition of certification processes;
- accelerated institution of technical regulations based on the EU's "New Approach" Directives.

The PCA contains instructions on adapting to EU standards, provides for measures to support growing capacity in government institutions for standardization, international accreditation of Ukrainian organizations, expert assessment of conformity, and supervision of the market. Ukraine intends to gain partial or full membership in European standardization organizations such as CEN (the European Committee for Standardization) and the CENELEC (the European Committee for Electrotechnical Standardization).

It is expected that Ukraine will further integrate into the global system of standardization and conformity assessment. The next step after Ukraine's accession to the Agreement on TBT/WTO will be accession to the Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA). This will guarantee mandatory mutual recognition of products. That is, Ukrainian goods will be delivered to the EU with a symbol of conformity to European standards whose legality will have been confirmed by Ukrainian bodies han-

dling conformity issues. So there will be no need to have further tests in the EU. The same is will be true of EU imports to Ukraine.

The ACAA covers the so-called old approach in which products are subject to detailed coordinated standards that are duplicated by Ukraine and the new EU approach, based more on mutual recognition and containing more simplified norms. Achieving complete mutual recognition requires the establishment of a perfect "quality infrastructure:" starting with the inclusion of EU standards in Ukrainian legislation and ending with the institution or reform of the necessary bodies to carry out this legislation and issue certificates of conformity.

In 2005, the European Commission presented Ukraine a plan of actions in the context of the ACAA. This plan was modeled on the experience of accession candidates and Mediterranean countries. This plan proposes beginning with a multi-level process of identifying priority sectors. These activities are expected to be completed by 2011, when the ACAA comes into force. Ukraine reached agreement with the EU on the provision of technical assistance to implement the Action Plan in this area as a part of the TACIS program.

The European Commission through the TACIS program and the World Bank through the "Programmatic Adjustment Loans" will provide technical assistance and methodological recommendations for harmonizing Ukrainian product quality standards to EU ones. For example, the State Committee for Technical Regulation and Consumer Policy has been mandated to adopt standards independently, rather than through the Cabinet of Ministers, as it did before.

The Generalized System of Preferences

Ukrainian exports to the EU has been a subject of the Generalized System of Preferences (GSP) since 1993. The benefits of the GSP have been known to reduce the EU customs tariffs for goods imported from Ukraine up to 2%, while rates for countries enjoying most-favored-nation status are about 4%.⁷

Ukrainian exporters do not take advantage of all the GSP has to offer. For instance, in 2001, they submitted applications for preferences on only 50% of exports to the EU. The reasons behind this incomplete use of these preferences is the low level of awareness among Ukrainian exporters about what the GSP offers, difficulties fulfilling EU preference rules in terms of identifying the origin of goods, and the relatively insignificant size of the breaks for some types of commodities. Due to the comparatively high costs of confirming the origin of products, the level of preference use is relatively higher in sectors where large companies dominate (steel and petroleum products) than in sectors where smaller companies are typical (clothing, fruit and vegetable pro-

⁷ The World Bank, 2004 study on Ukraine's trade policy.

cessing). This can provide a reason to expand technical assistance programs for exporters in sectors where SMEs are pre-dominant.

The European Union's Generalized System of Preferences (GSP)

The European Union's Generalized System of Preferences provides customs-free access or lower customs rates for certain products imported from beneficiary countries—developing countries and transition economies. The GSP covers only those goods subject to import duty. Some 2,100 commodities from among nearly 10,300 tariff categories in the Common Customs Tariff, are subject to a zero import duty as part of the most-favored-nation (MFN) status and they are thus excluded from the GSP, as is commodity group 93—weapons and ammunition.

The GSP is implemented in 10-year cycles. The current cycle began in 2006. The GSP is carried out through regulations issued by the EU Council of Ministers (Council Regulations). Council Regulation №980/2005 is in effect from 1 January 2006 to 31 December 2008 and consists of three agreements:

- the general agreement relating to all beneficiary countries, including Ukraine;
- the agreement with special incentives for sustainable development and good governance (GSP+), which covers 15 countries that meet certain criteria;
- the special agreement, known also as the “Everything But Arms” initiative (EBA), relating to the 50 least developed countries.

The first two agreements cover some 7,200 commodities, with 3,900 classified as sensitive and the rest non-sensitive goods. For countries belonging to the first group, non-sensitive commodities receive customs-free access, while sensitive goods receive a reduction in the customs duty rate: 3.5 pp for *ad valorem* duty and 30% for the specific duty. Textiles and clothing are an exception, having a reduction of 20% of the rate offered with most-favored-nation status.

Harmonizing Ukrainian legislation with the *acquis communautaire*

Ukraine is making efforts to bring its national legislation in line with EU standards according to commitments of the Partnership and Cooperation Agreement. According to Art. 51 of the PCA, “an important condition for strengthening the economic links between Ukraine and the European Union is the approximation of Ukraine's existing and future legislation to the legislation of the European Union. Ukraine shall endeavor to ensure that its legislation will be gradually made compatible with the legislation of the European Union.” Art. 51 identifies 16 areas for approximation, including those related to trade facilitation: customs law, technical rules and standards, and food safety. Since 1996, Ukraine has done serious legislative work in these areas, coordinated by the Ministry of Justice and supported through EU technical assistance. The Ukrainian – European Policy and Legal Advice Centre (UEPLAC) subjected all 16 ar-

eas to critical analysis as to the degree of approximation to EU norms in every key legal instrument. The results of this analysis are summarized in **TABLE 2**.

Table 2. *Levels of approximation of Ukrainian legislation to the *acquis communautaire* in trade (Art. 51 of the PCA) as of 2004⁸*

Sector of application	Number of Ukrainian laws			
	Approximated	Nearly approximated	Approximation in progress	Not approximated
	The legal instrument is very similar to the relevant EU legislation	The main components of the legal instrument are in the internal legal system; the legal instrument was developed with its EU counterpart in mind	The first steps to implement this legal instrument have been taken; the process of developing a comprehensive draft is underway	The specific legal instrument is so nascent as to effectively be absent in Ukraine's legal system
Customs law	—	1	4	—
Technical standards	—	—	11	3
Food safety	8	3	24	2

The main challenge to Ukrainian legislation regarding compliance with the *acquis* is not the adoption of new laws, but their proper enforcement. In many areas, the country has relatively new laws, but they are not adequately applied in practice or are not observed at all. Yet, the observance of laws is a key point in the EU's Internal Market. To progress in this area, Ukraine will have to resolve many structural problems, including weak government institutions, an extremely outdated legal system, underdeveloped regulatory bodies, and large-scale corruption. As long as these problems remain unresolved, Ukraine will not be able to make real progress in observing the *acquis communautaire*.

⁸ For more detailed information on the degree that Ukrainian legislation matches the *acquis communautaire*, see "The Review of the Progress Achieved in Approximating Ukrainian Legislation to the *Acquis Communautaire*" by the State Department for the Approximation of Legislation.

Trade facilitation after WTO accession

Currently, the main reason for reforms in Ukraine's trade policy is the country's accession to the World Trade Organization, as this important event will also help Ukraine resolve some key issues in bilateral trade policy, such as canceling EU quotas for steel imports from Ukraine.

Ukraine's last comprehensive proposal for rates that consolidates the results of bilateral negotiations is formally confidential, but its key provisions are already known. It is likely that, after the country's accession to the WTO, average import duty will be no more than 5% for industrial goods and around 11% for farm products at the end of the transition period, around 2010.

Trade facilitation within the WTO

Steps to facilitate trade are included in many WTO agreements:

1. the 1994 GATT: Art. V (Freedom of Transit), VIII (Fees and Formalities Connected with Importation and Exportation) and X (Publication and Administration of Trade Regulations);
2. the Agreement on Customs Valuation;
3. the Agreement on Rules of Origin;
4. the Agreement on Pre-Shipment Inspection;
5. the Agreement on Import Licensing Procedures;
6. the Agreement on Technical Barriers to Trade (TBT/WTO);
7. the Agreement on the Application of Sanitary and Phyto-Sanitary Measures;
8. the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

All articles, brief descriptions and explanations of these agreements can be found at: http://www.wto.org/english/tratop_e/tratop_e.htm. Current work of the WTO on trade facilitation issues is highlighted at: <http://docsonline.wto.org/>.

Several significant **changes in legislation** related to trade facilitation have already been introduced. They reflect technical aspects such as sanitary and phyto-sanitary standards and technical restrictions on foreign trade:

- Enforcement of the Law "On standards, technical regulations and the procedure for assessing conformity"⁹ will help bring national legal requirements in technical regulation, standardization and conformity assessment in line with WTO norms and principles. This Law will make it possible to significantly simplify the procedures for cooperation in technical regulation, standardization and conformity assessment between Ukraine and WTO member countries;

⁹ The 1 December 2005 Law №3164-IV.

- The Law “On amending the Customs Code of Ukraine” regarding the regulation of issues related to determining customs value of goods came into force in March 2006. Amendments introduced by this Law provide for clearer regulation of the mechanism for determining customs value, identify the obligations and responsibilities of customs officers who oversee correct identification of the base of customs taxation, and declarants who submit information about the customs value of goods. The application of norms written into this Law helped bring provisions of the Customs Code on customs valuation of goods in line with requirements of the Agreement on Implementation of Art. VII of the GATT 1994.

In addition, the country developed a Concept for a system of regulation and consumer policy and a strategic plan to implement this Concept over 2006–2010. According to explanatory briefs from the State Committee for Technical Regulation and Consumer Policy (Derzhspozhyvstandart/CTRCP), the final goal of implementing the 2005–2010 compliance Action Plan is to achieve full compliance between the national system for standardization and technical regulation and the Agreement on Technical Barriers to Trade (TBT) of the WTO. This Plan establishes stages for developing and instituting regulations and organizes the harmonization of current Ukrainian standards with international ones. This document also contains a Plan for revising standards that are valid in Ukraine to determine which ones need to be cancelled or replaced by international standards.

Intensive harmonization of national standards with international and global standards is underway. According to the CTRCP, some 3,100 or more than 30% of national standards had been harmonized as of late 2005. The approved harmonized standards are related to the requirements for and methods of oversight of food products, the quality of potable water, air, soil, farm machinery, fertilizers, fodders, dishware, electrical household appliances, medical instruments, information technologies, digital television broadcasting, elevators, personal safety devices for employees, and woodwork.

After accession to the WTO, Ukraine will join the Agreement on Technical Barriers to Trade. According to its provisions, as well as Arts. 51 and 56 of the PCA between Ukraine and the EU, and Sec. 30 of the Ukraine–EU Action Plan, the country will gradually adapt and approximate its system of technical regulation to international and EU rules and standards. Ukraine is already negotiating with its trading partners to set up a contractual and legal base for cooperation in standardization and conformity assessment according to Art. 6 of the Agreement on TBT/WTO.

Ukraine will also join the WTO Agreement on Rules of Origin. This contains basic principles for rules of origin, but not detailed harmonized rules that must be used by all members of the WTO. In addition, this Agreement involves only the rules of origin applied in normal trade relations, not any rules in regional

and bilateral preferential trade agreements. Moreover, it paves the way to the harmonization program whose goal is to make the rules of origin more predictable, objective and comprehensible. It is important that these rules are positive in terms of their approach, that is, to point to what confirms origin and not to what fails to do so. The WTO continues to work on rules of origin. The final result could be a single list of rules of origin that would be equally applied by all WTO members in non-preferential trade regimes.

Deep free trade (FTA+) the best option

For Ukraine, the choice between a simple and a deep free trade with the European Union largely depends on how prepared the country is to carry out either option. In the broader sense, for Ukraine, this means finding a compromise between what is easily implemented and what benefits will be incurred. Simple free trade is the easiest to implement, but its impact will be minor. Deep free trade is much more exacting at the institution stage, but promises significant economic benefits that are of strategic importance in the future.

Simple free trade

Based on what is agreed, **import duties** are eliminated asymmetrically in this model: for the EU, when the agreement comes into force, given the high competitiveness of European goods; for Ukraine, in 5–10 years. This will allow Ukrainian enterprises to gradually adjust to a more open market, without losing their competitive advantages at once. Duties for industrial goods will be eliminated fairly quickly, while tariffs for farm products will be eliminated more gradually, leaving exceptions in place because of the special attitude of both sides to this sector. Rates will be reduced gradually, in equal amounts.

The transition period for some especially sensitive goods could last up to 10 years. However, the inconvenience of a lengthy transition period is that the formation of the FTA+ could lose the initial goodwill and fail to stimulate private sector development. Overall, a lengthy transition period flies in the face of the political need to guide Ukraine's economy towards new growth. For this reason, we recommend that any transition period last no more than five years.

The asymmetric cancellation of customs duties is typical for EU FTAs. For example, with Poland the EU eliminated its duties in five years, while Poland took 10 years to do so, after their Free Trade Agreement came into force. Poland also cancelled its export duty more than five years later. Agreements with Mediterranean countries call for the EU to cancel rates immediately after these agreements come into force, while member-countries are to eliminate customs duties within transitions period lasting from 10 to 12 years. Again, some farm products were exempt.

The 2002 Agreement between the EU and Chile divided commodities into categories so that duties in each category were eliminated at various points: some after the agreement came into force, others in 3, 4, 7, and 10 years.

After acceding to the WTO, Ukraine will reduce, but not eliminate, certain **export duties**, such as for scrap metal, sunflower, livestock and rawhide. The remaining export duties will be eliminated under the free trade regime with the EU.

It is fairly easy to set up a modest, basic free trade area that cancels import duties, with the probable exception of agricultural products:

- the Ukrainian Government will have sufficient administrative capacity to develop, institute and oversee the enforcement of the needed changes to the Customs Code of Ukraine;
- the institution of changes will not face significant political resistance;
- the competitiveness of Ukrainian products on European markets will rise, without losing the domestic market;
- trade under a zero-rate customs duty regime will not require employees of customs houses and cross-border traders to have additional training or qualifications.

However, a simple FTA will not provide significant benefits, as the most serious obstacles to developing foreign trade that will remain even after Ukraine's accession to the WTO will be non-tariff barriers: different standards for products and complicated customs procedures.

Deep free trade (FTA+)

As with a simple free trade area, an FTA+ will primarily involve the bilateral cancellation of import and export duties. However, the main focus will be on eliminating non-tariff barriers. In addition to harmonizing Ukraine's standardization system with EU norms, it will contain the agreement on the rules of origin for goods and steps to simplify customs procedures and combat corruption. These will mainly be related to Ukrainian Customs.

The EU can help Ukraine resolve customs problems by providing technical assistance to Ukraine's border guards and financial assistance to purchase modern border security equipment. In return, the EU can expect comprehensive customs reform and the simplification of border control in Ukraine.

The key issue in negotiations on a Deep Free Trade Agreement will be the degree of approximation to European regulatory norms and technical standards. It will be necessary to identify the optimal set of measures and timeframes for approximation, which must be developed on the basis of cost-benefit analysis on both sides. The integration experience of the latest EU Member States points to significant short-term costs that were sustained while trying to achieve full compliance with EU standards and rules. It was ultimately achieved because of significant financial and technical assistance and of political incentive in form of the future full-fledged membership.

Trade facilitation as part of an FTA+

As a rule, EU requirements for trade facilitation depend on the actual degree of liberalization of trade in a partner country, as well as on the willingness and capacity of that country to implement specific measures to facilitate trade. For example, the part of the FTA with Chile that contains terms and conditions for facilitating trade is broader and more detailed than bilateral agreements on a free trade area with Mediterranean countries.

Customs tariffs

After accession to the WTO, the average weighted import duty rate for industrial goods will be 5% in Ukraine. In the EU, this rate will be 4% with most-favored-nation status and about 2% in the Generalized System of Preferences. The tariff structure in Ukraine is not overly liberal, but it is less protectionist than, for example, in Russia. On average, it complies with the tariff structure of Central European countries just before they acceded to the EU.¹⁰

The establishment of a free trade area between countries means primarily the cancellation of all import and export duties. For Ukraine and the EU, the easiest part will be to reach agreement on this aspect. Key negotiating points will be:

- exemptions to the FTA+;
- transition periods for the most sensitive products;
- asymmetric zeroing of rates.

According to ICPS economists, the creation of an FTA+ will have a tangible economic impact only if there are no exceptions and restrictions. Otherwise, the benefits will be outweighed by administrative costs. The best option for Ukrainian producers will be asymmetric nullification of rates: the EU reduces import duties immediately after the FTA comes into force, while Ukraine does this over a transition period. The duration of this period will depend on the competitiveness of domestic goods in a specific commodity group. Producers need to use this transition period to re-equip their production facilities and prepare for stronger competition with EU goods on the domestic market. However, this transition period should not be long—ICPS analysts recommend no more than five years—in order to avoid canceling out the potential benefits of setting up an FTA+.

¹⁰ Op. cit, 2004 World Bank study.

Standardization, technical regulation and conformity assessment

After import duties are cancelled, the rapid growth of imports to both sides will be hindered by technical barriers, such as different requirements as to product quality, specifications and the process of conformity assessment. These are the main obstacles to Ukraine's foreign trade, especially with the EU. The number and requirements of such technical regulations is growing in developed countries as these governments pay ever-greater attention to product safety and environmental protection. Unlike these countries, however, Ukraine currently has barriers to the development of trade that are due to internal mechanisms for the administration and oversight of enforcement of various regulations and laws.

EU legislation on technical regulation is based on the European New and Global Approach Directives. It is supplemented by a triad of directives related to liability for defective products and overall product safety, and to a modular approach to conformity assessment and marking product "CE." There are also many directives from the old approach regarding specific types of products. There are special laws or Government decisions on standardization and certification, metrology, market oversight, and accreditation. Specific laws and pieces of legislation regulate the safety of food products and the protection of consumer rights.¹¹

The regulatory base of each EU country covers all European standards (currently, there are about 18,000) adopted by the EU standardization organizations CEN (the European Committee for Standardization) and CENELEC (the European Committee for Electrotechnical Standardization). Each country adopts them as national standards. There are also purely national standards (from 2% to 30% of the total number of standards) that reflect the specific features of the specific economy.

These standards are voluntary. One part of these standards serves as evidence of compliance to the requirements of European directives. These standards are developed by CEN and CENELEC based on a special mandate from the European Commission.

The issue of product standardization is a key issue in negotiations to set up an FTA+: Ukraine's standards and procedures for conformity assessment differ from European ones and will effectively close EU markets to the majority of Ukrainian goods even if customs rates are zeroed. Given this, the European Commission and Ukraine are developing a general plan for making the country's technical standards for industrial goods comply with European ones by 2010.

¹¹ According to the materials of a White Paper called "Adapting National Legislation on Technical Regulation and Consumer Policy to European Standards" by the State Committee for Technical Regulation and Consumer Policy, 2006, [http://www.icps.com.ua/doc/White % 2009 % 20 - % 20Technical % 20Regulation % 20Committee % 20E.pdf](http://www.icps.com.ua/doc/White%2009%20-%20Technical%20Regulation%20Committee%20E.pdf)

Harmonization of internal standards with EU ones will involve:

- **INSTITUTING EUROPEAN STANDARDS IN UKRAINE USING THE SECTORAL METHOD**, with broad involvement of producer associations. A schedule for changing standards needs to be developed, starting with sectors where standards are approximated to European ones to the maximum or where part of producers has already independently undergone European certification and postponing changes in sectors where standards differ significantly. Clear-cut deadlines for completing the harmonization of standards will make it possible for producers to adjust their manufacturing processes to the new, mostly stricter requirements as to product quality.
- **SWITCHING FROM MANDATORY TO VOLUNTARY CERTIFICATION OF PRODUCTS**. This will require close cooperation with producers, who must be taught to independently institute quality control systems, and a simultaneous decline in pre-market control by government bodies. It will be important to educate society in consumer culture, so that individuals learn to check the quality of goods and appeal to government oversight bodies where products prove to be of poor quality. EU technical assistance will make it easier to acquire the needed skills, not only among employees of government certification bodies, but also for independent agencies, which will expand the network of such institutions in Ukraine.
- **MUTUAL RECOGNITION OF CERTIFICATES**. This will simplify export-import operations.
- **CARRYING OUT PUBLIC AWARENESS CAMPAIGNS** (including a special website). This should familiarize producers with current and planned changes in standards for products, and provide contact information regarding institutions engaged in certification and conformity assessment and electronic copies of all necessary documents with samples of how to fill them out. This should significantly simplify interaction between producers and regulatory bodies, reduce procedural costs and accelerate the export process.

To identify the optimal degree for harmonizing Ukrainian standards with European ones, three criteria should be used:

- Does it facilitate enhanced market integration?
- Does the EU law or standards comply with global best practice?
- Does it foster economic reform?

To minimize harmonization costs and ensure rapid transformation to the new system, a simple translation of EU norms into Ukrainian should be used, without any modifications. Poland used this approach to harmonize standards. Ukraine should not make European or international standards mandatory if they are voluntary within the EU itself. It is better to make it possible for

producers to voluntarily use standards if they intend to enter the European markets or to compete with the European goods on the Ukrainian markets. Thus, the country will switch from the mandatory system inherited from of the State Standards Committee of the USSR to the mainly voluntary European approach. Ukrainian companies will also be able to continue manufacturing products for the CIS markets using the old standards.

The preparation and negotiations of Ukraine's accession to the Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA), with broad coverage of industrial goods, is a strategic move in the area of technical standards. The timeframes proposed by the European Commission in the Plan of Action towards the ACAA (2005 – 2011) are realistic in terms of the depth of reforms needed to adjust the system of standards. At the same time, implementing this Plan will make it possible to harmonize Ukrainian standards with European ones before the agreement on setting up an FTA+ is signed. This, in turn, will increase benefits from customs-free trade between the countries immediately after the deep free trade agreement comes into force.

Customs procedures

In its study of Ukraine's trade policy,¹² the World Bank looked at regulatory obstacles as perceived by Ukrainian exporters. After interviews with 500 exporters, it became clear that the main obstacles to exports are 14 components of Ukraine's trade regime:

- VAT refunds;
- customs clearance in Ukraine (documents);
- customs control;
- customs service fees;
- customs permits to process raw materials abroad;
- temporary storage of goods at customs warehouses;
- establishing price indicators for goods;
- licensing export activities;
- transporting goods across Ukrainian territory;
- registering an export contract;
- mandatory insurance;
- customs clearance abroad (documents);
- money transfers;
- obtaining certificates of origin.

In response to a question about the main reasons behind their negative evaluation of Ukraine's trade regime, exporters mentioned six interrelated reasons:

¹² Op. cit., 2004 World Bank study.

- the frequent need for “unofficial payments;”
- arbitrary interpretations of rules by officials;
- frequent changes in requirements;
- contradictory and vaguely formulated customs rules;
- overly long bureaucratic decision-making;
- the high cost of meeting regulatory requirements.

The main reasons behind the negative attitude of Ukrainian exporters towards cooperating with customs officials included unreasonable requirements for the clearance of goods, high costs and dilatory procedures—and the high level of corruption in Customs. The identification of prices for goods and the designation of codes for goods when registering export operations are currently quite subjective. In addition, exporters are frequently forced to use unnecessary customs services for which they later have to pay excessive charges. According to the World Bank study, in 2004, a single customs clearance lasted 3.2 days on the average and cost US \$156.60—not counting customs duties or export taxes.

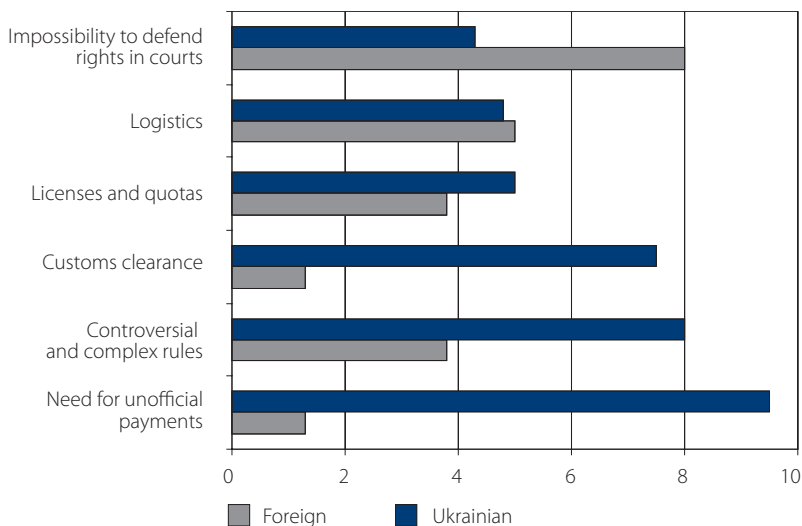
The current export regime typically and repeatedly requires that companies planning to engage in export activities undergo preliminary registration and get permits. These administrative requirements are fairly arbitrary and a significant number of respondents admitted that they avoid them. The vast majority of respondents mentioned registration: 73.8% have applied to customs bodies for it. The next biggest complaints are having to register export contracts frequently (24%) and having to get export licenses (21%). In addition, 41% of respondents said they had to obtain other types of export permits, although each specific type of permit was needed by a relatively insignificant portion of respondents. These registration requirements constitute a major regulatory burden on exporters, as the average price for permits and licenses is in the range of US \$40 – 180.

This study also revealed that Ukrainian exporters face more problems at home than abroad (see **CHART 1**).

The country's accession to the WTO will mean that Ukraine meets standards related to the Customs Code and customs valuation. However, this in itself does not mean that customs services will now be quick and efficient. In working groups with neighboring countries, the European Commission developed instructions for the best methods for action at the border crossing points and submitted proposals for “a simple, paperless environment for both Customs and the movement of goods” in terms of integrated management on external borders. These proposals contain complicated programs for modernizing and computerizing trading procedures, for example, using electronic declarations and examining goods with the help of X-rays at border crossing points.

Chart 1. Evaluation of Ukrainian and foreign barriers to exports as of 2004

0 – no problems; 10 – very serious problems



Source: World Bank

For the effective operation of an FTA+, the country needs to decisively combat corruption at its border crossings. Two crossing points between Poland and Ukraine have already launched a program of cooperation. Accordingly, two groups from the two countries are working in immediate proximity to each other: in Zosin – Ustilug (close to Zamosci) and Kroscienko – Smolnica in the southeastern Poland. The Ukrainian and Polish customs officers check passengers and freight independently but within sight of one another. It has turned out that this psychological approach helps reduce corruption.

The issue of simplified customs procedures is extremely important and urgent within the European Union itself. One of the most important steps in this area is to set up a common electronic database that can make customs control a paperless procedure. In addition, there is a need to divide the functional responsibilities of Customs services: only the quality of products need to be examined immediately at the border, while fiscal functions like the collection of duties and taxes can better be fulfilled elsewhere. As part of setting up an FTA+, Ukraine could use the experience of the EU in optimizing customs clearance of goods by directing its Customs reforms in the same direction. Ukraine's accession to the common European database would give its exporters indisputable advantages over importers from third countries.

Facilitating freight across a border using technology: the North American experience

Once an FTA+ agreement is signed, movement across the EU–Ukraine border could become similar to that on the US–Mexico border, where the North American Free Trade Agreement (NAFTA) resulted in significant expansion of bilateral trade, largely thanks to direct US investment in Mexico. The excellent work of border crossing points is the result of the FAST (“Free and Secure Trade”) program, which is in effect on the basis of a bilateral “Border Coordination Initiative” between the US and Mexico.

When drivers approach the strip where the FAST program is in operation, the inspector receives information about the driver, freight and carrier company in wireless mode. An imaging system reveals the interior of the truck. This system will reveal hidden compartments or cargo that does not match the declaration. This technology facilitates rapid movement through border crossing points while making it possible to instantly reveal suspicious freight.¹³

Rules of origin of goods

Rules of origin of goods are divided into preferential and non-preferential treatment. The rules related to non-preferential treatment are applied to implement trade policy measures (quotas, anti-dumping investigations) and to collect statistical data. Preferential treatment is given to goods that meet preferential rules of origin. These rules will be applied to Ukrainian goods if a Free Trade Agreement is signed between Ukraine and the EU.¹⁴

By using rules of origin, the EU protects its markets from duty-free imports of goods from countries that do not enjoy preferences through the customs territory of countries that do. The main drawback of the rules of origin is that they impose additional costs on participants in a free trade area, especially in countries with poorly developed customs services. This diminishes the value of preferential agreements with the EU.

The rules of origin of goods contain various criteria for identifying the origin of a product and, thus, preferential access to the market. According to European rules of origin, a commodity originates from a given country if it was “wholly produced” in this country or was subject to “substantial transformation” there. “Substantial transformation” has taken place if one of these three criteria applies:

- minimum value-added: was the indicated minimum value added to the product (in percentage, based on the ex-works price for goods)?;

¹³ *FAST Reference Guide. Enhancing the Security and Safety of Trans-Border Shipments.* US Department of Homeland Security, US Customs and Border Protection, 2005.

¹⁴ Hereinafter, the term “rules of origin of goods” will be used to mean preferential rules.

- change in commodity group: was the commodity transformed to such an extent that this good's commodity group has changed?;
- specific process: was the commodity subjected to the indicated type of processing? Frequently, this rule contains a list of production processes that will not suffice to consider the commodity as originating from the country in question.

The rules of origin of goods applied in the EU constitute one of the main obstacles for Ukrainian producers to full-fledged use of the Generalized System of Preferences that has been applied to goods made in Ukraine since 1993.

One of the ways to reduce the restricting influence of the rules of origin is cumulation. Cumulation of origin makes it possible to view imported materials from certain third countries as materials originating from the beneficiary country. This means that preferential access to the market of the donor country is granted to a broader base of goods. As a rule, cumulation is allowed with the donor country itself. Occasionally, it is allowed with other countries that enjoy the same privileges, generally within the same region. For example, there are North-African and Pan-Asian Cumulation Systems as part of the Generalized System of Preferences. The higher the level of cumulation is—e.g., the more countries whose raw materials meet the rules of origin—the more liberal the rules of origin are and the easier it is to meet them. Exporters will be less constrained in the choice of resources and will less frequently choose non-optimal sources of raw materials to fulfill the rules. This, in turn, will make them more competitive.

Practice has shown that the rules of origin attached to a Free Trade Agreement by the European Union are not open to negotiation. Moreover, the kinds of rules proposed by the EU are generally developed using a somewhat untransparent mechanism to protect certain markets and not to facilitate trade: the greater protection certain sector needs, the stricter the rules of origin for the related goods are. As a rule, no analysis is performed to justify the expediency of including specific rules of origin of goods in a new free trade agreement.

Therefore, the objective of an FTA+ between Ukraine and the EU is to reduce the restricting effect of rules of origin on trade. This can be achieved by Ukraine's accession to the Pan-Euro-Mediterranean Cumulation System. This would make it possible for Ukraine to use raw materials from EU Member States, Turkey and some Mediterranean countries to manufacture goods that later will be exported to the EU duty-free. In addition, it is important that similar rules of origin of goods be instituted for imports to Ukraine. This will protect the Ukrainian market from re-exports of goods from third countries through the EU.

The Pan-Euro-Mediterranean Cumulation System

The Pan-European Cumulation System (PECS) was set up in 1997 and enlarged in 1999. Currently, it includes all EU Member States, countries covered by the European Free Trade Association (EFTA)—Iceland, Lichtenstein, Norway, and Switzerland—, and Turkey. In fact, it also covers Andorra and San Marino, which have established a customs union with the EU. Currently, the cumulation system also includes the Faeroe Islands and Mediterranean countries. This is why, recently, it began to be called the Pan-Euro-Mediterranean Cumulation System.

The Pan-Euro-Mediterranean Cumulation System uses diagonal cumulation: goods that have obtained the status of origin in one of the system's 43 countries can be used in production processes in any of the other countries, without losing the status of origin from this territory. Diagonal cumulation is based on the rule of "variable geometry:" the cumulation of status of origin is allowed only to countries that are parties to a free trade area.

The FTA+ impact on trade facilitation

Under the deep free trade arrangement between Ukraine and the European Union, both sides will gain a powerful incentive to develop their economies. The proposed reforms related to foreign trade activity will also be positive for other sectors—improving the domestic business environment, attracting more foreign investment and enhancing the domestic market. Possible economic losses for inefficient producers will be more than compensated by growing profits for other producers, a better standard of living for ordinary Ukrainians, and the emergence of new opportunities for developing business in Ukraine.

The impact on the country as a whole

The conclusion of a Free Trade Agreement between Ukraine and the European Union makes sense only if its positive consequences outweigh the costs of developing and implementing the Agreement. The impact can be divided into three groups:

- economic;
- social;
- environmental.

In terms of improving trading conditions, an FTA+ will not have a direct impact on the quality of the environment. However, it can have an indirect impact by expanding production in certain sectors of the economy, which will certainly take place once an FTA+ is set up. For example, the current relatively high level of adjustment of the metal industry to European requirements and high demand for metals in the EU will encourage expansion in this sector.

The social consequences of setting up an FTA+ will depend on what economic results are achieved, as the volume of resources channeled into resolving social issues will depend directly on national income.

Economic consequences can be roughly described through changes in macroeconomic indicators:¹⁵

¹⁵ To evaluate the economic impact of setting up a free trade area between the EU and Mediterranean countries, several groups of indicators were used: real income (includes GDP, the Consumer Price Index and the exchange rate), fixed capital investment (includes the level of savings and investment, foreign trade balance, the current account balance) and the rate of unemployment.

- GDP;
- Consumer Price Index;
- the exchange rate;
- the balance of trade in goods and services;
- public finances;
- the unemployment rate.

Having no model of the Ukrainian economy or knowledge of initial conditions in the country and in the world at the point when the Deep Free Trade Agreement comes into force, only a qualitative, not a quantitative, analysis of the consequences of setting up an FTA+ can be made at this time.

Analysis according to economic components

Economic indicator	Impact ¹⁶	Description of impact
GDP	↑	Ukraine's GDP will grow: improved access to the EU markets will provide incentives for expanding production of Ukrainian goods. Stronger competition on the domestic market will result in more efficient use of resources
The Consumer Price Index	↑	The CPI will slow down: stronger competition with imported products will provide incentives for Ukrainian products to keep prices in check. The shrinking cost of import operations will make it possible to keep prices for goods imported from the EU down
The exchange rate	↑	The hryvnia exchange rate will become more flexible: the setting up of an FTA+ will foster the country's transition to a freely convertible hryvnia. With rising exports, growing foreign currency revenues will have a positive impact on making the hryvnia, establishing it as a strong currency that can reject the fixed exchange rate system
The balance of trade in goods and services	↑↓	Reduced trade barriers will provide incentives for expanding the movement of goods between the countries in both directions. The intensity of expanding exports or imports will depend on the progress of reforms and the readiness of all sides to cut down protectionist measures
Public finance	↓	The preparation and implementation of customs reforms, the development and institution of new standards and rules of origin will require more public spending. The dropping of import duties for European products will cut into Budget revenues
Unemployment	=	A growing number of jobs at export-oriented companies will be matched by shrinking production at the least efficient businesses—those that cannot stand stronger competition. These processes will take place simultaneously and will be similar in terms of their intensity

¹⁶ "↑" — positive impact; "↓" — negative impact, "↑↓" — contradictory impact, "=" — insignificant or no impact.

The impact of specific components of an FTA+

Cancellation of import duties

The cancellation of import duties will have a direct impact on Budget revenues, which will shrink the equivalent of import duties for products imported from EU countries.¹⁷ At the same time, the time needed for accompanying procedures such as paying customs duties will be cut and the efficiency of customs operations will grow.

With import duties at zero, European products will become cheaper on the domestic market, which is good for Ukrainian consumers. Given that, at the moment, machinery, equipment and vehicles account for one-third of imports from the EU, lower prices for these products will encourage more rapid replacement of fixed assets and, thus, higher efficiency in Ukrainian industry. Stronger competition on the domestic market will primarily affect those who manufacture poor quality products. These companies will have to increase costs in order to raise the quality of their products and develop a more effective marketing strategy.

Producers could also feel competition on resource markets. Once export duties are dropped, exports of raw materials such as scrap metal and sunflower are likely to grow. This will raise domestic prices for raw materials and, accordingly, the production cost of Ukrainian goods. To protect Ukrainian producers from the possible negative impact of overly rapid liberalization, there needs to be a transition period.

Ukrainian exporters will reap the biggest benefits from cancelled customs duties: as they specialize mainly in products with low-end processing, price is the main factor determining their competitiveness.

Harmonization of standards, regulations and conformity assessment procedures

Budget expenditures to harmonize the national system of standards will have to be increased, but this can be partly compensated through financial and technical assistance from the EU. When the harmonization process is over, there will be more opportunities to export Ukrainian goods, not only to the EU, but to third countries as well. This should significantly boost Ukraine's export potential. The positions of domestic producers on the domestic market will also grow stronger, which should, among others, mean that Ukrainian consumers will enjoy a supply of better quality products. Opportunities for import substitution will increase, which, along with expanding exports, will

¹⁷ According to ICPS estimates, annual revenues from import duties could shrink by US \$600mn.

foster an improvement in the country's foreign trade balance. By saving time on confirming the quality of imported goods, importers of European products will be able to more rapidly respond to changes on Ukraine's domestic market. At the same time, as CIS countries recognize EU standards, producers oriented towards these markets should not have problems with exports to the CIS markets.

Simplification of customs procedures

The simplification and computerization of customs procedures will help combat corruption, cut costs by reducing Customs staff, and foster growth of foreign trade turnover. At the same time, simplification will require that Customs facilities be re-equipped and their specialists re-trained.

The indisputable beneficiaries of simplified customs clearance will be Ukrainian producers, who will not only be able to reduce the time for their products to reach European markets, but also to optimize the way they deliver raw materials and semi-finished products. Moreover, they will be able to respond better to changes in the internal and external situations and their overheads will be reduced. Should customs reform be successfully implemented on the border with the European Union, similar changes will take place on both the northern and eastern borders. This will simplify the export operations of companies producing for CIS markets. The simplification and acceleration of export and import operations will better satisfy the needs of Ukrainian consumers and make products on the domestic market less expensive.

Harmonization of the rules of origin

To prevent EU-based re-exports of goods produced in third countries, Ukraine will have to revise its system of rules for origin of goods. Like other reforms, this will require expenditures from the State Budget. Mutual recognition of certificates of origin will allow for close cooperation between the relevant bodies in Ukraine and the EU.

To take the fullest advantage of preferential access to European markets, Ukrainian producers will have to be more choosy about their sources of raw materials and to check the availability of all documents needed to confirm the origin at all stages of production. The opportunities for Ukrainian producers to diversify deliveries of raw materials—and, thus, to reduce their production costs—will remain more limited, as European producers will continue to have a broader choice of suppliers from among countries in the Pan-Euro-Mediterranean Cumulation System.

The impact on stakeholders

The changes in trade facilitation that come with the establishment of an FTA+ will affect the economic interests of many stakeholders. An FTA+ will have both positive and negative consequences for nearly every stakeholder. Moreover, at times a reform that is positive for some groups will be negative for others. This means that finding the optimal balance among the interests of all stakeholders must be a core objective in setting up any FTA+ between Ukraine and the EU.

Analysis according to stakeholders

Stakeholder	Pros	Cons
The State	<ul style="list-style-type: none"> Implementation of internal reforms in customs, standardization and conformity assessment with partial compensation of costs by the European Union Reduced administrative costs for the operation of Customs and other government bodies Elimination of corruption at Customs and in state certification bodies Growing exports to the EU and third countries, an improved balance of trade 	<ul style="list-style-type: none"> Shrinking Budget revenues from customs duties Expenditures to harmonize standards Expenditures to re-train specialists in the standardization of goods and customs clearances Expenditures to re-equip technical labs and customs houses
Consumers	<ul style="list-style-type: none"> Lower prices for European goods on the Ukrainian market Higher quality domestic and imported products The rapid entry of new goods to the market 	
Exporters	<ul style="list-style-type: none"> The acquisition of competitive advantages over other exporters to the EU Lower prices for Ukrainian goods on European markets Better quality Ukrainian products Savings in both time and money on export operations Potential expansion of sales markets in third countries 	<ul style="list-style-type: none"> Possible price hikes for resources on the domestic market as more resources are exported to the EU The need to adjust to new standards for products and to institute quality control systems
Importers	<ul style="list-style-type: none"> Lower prices for goods on the Ukrainian market Savings in time spent on customs inspections of goods and accompanying procedures Better response to changes on the domestic market 	<ul style="list-style-type: none"> Stronger competition with Ukrainian producers
Producers oriented on the domestic market	<ul style="list-style-type: none"> Voluntary improvement in the quality of products Cheaper investment costs More rapid entry on external markets in case of unexpected changes on the domestic market (avoiding overproduction crises) 	<ul style="list-style-type: none"> Stronger competition with European producers. Possible price hikes for resources on the domestic market as more resources are exported to the EU Expenditures on adapting to new standards and re-equipping production facilities
Russian trading partners	<ul style="list-style-type: none"> Imports of higher quality products from Ukraine Simplified customs procedures will be related not only to European trading partners, but also to all trading partners 	<ul style="list-style-type: none"> Stronger competition from better quality Ukrainian goods The impossibility of a customs union involving Ukraine



Agricultural products

Free trade agreements between the European Union and other countries have generally excluded the majority of agricultural products. That is why, in the context of a future EU–Ukraine free trade agreement, agriculture will be considered from two different standpoints. Areas in which free trade is possible and desirable for Ukraine should be defined. However, it is also crucial to consider the inclusion of agricultural products outside Ukraine–EU trade cooperation.

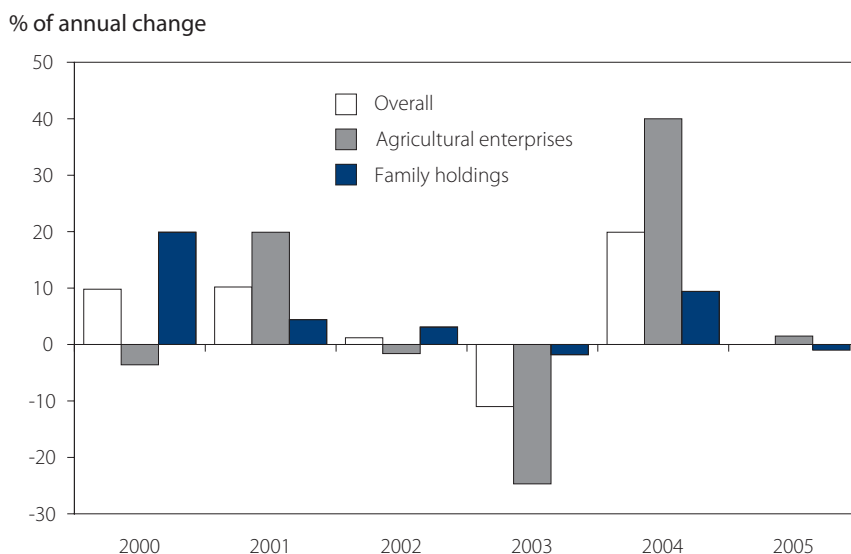
FTA+ could help attract EU investments, technologies and agricultural equipment to Ukraine, as well as training programs for Ukrainian farmers. The short-term goal of FTA+ is to adjust Ukrainian standards to those of the EU, raising the quality of goods and increasing the competitiveness of Ukrainian agricultural products for the long term.

A brief overview of the agricultural sector

Agriculture accounts for about 13% of Ukraine's gross value-added (GVA). About 5.7 million people are employed in the agricultural sector, or 19.8% of the able-bodied population. The difference between the share of GVA produced in the sector and the share of people employed in it reveals the sector's rather low productivity. Wages in agriculture are among the lowest in Ukraine. In 2005, the average salary in the sector amounted to UAH 415.02, which is 49% lower than the average Ukrainian's monthly salary.

The sector began to turn around in 2000. Since then, growth has been unsteady, which, for the most part, can be attributed to the sector's dependence on a crop, grain, that is known to be largely dependent on weather conditions.

Chart 2. *Production of agricultural goods*



Source: Derzhkomstat

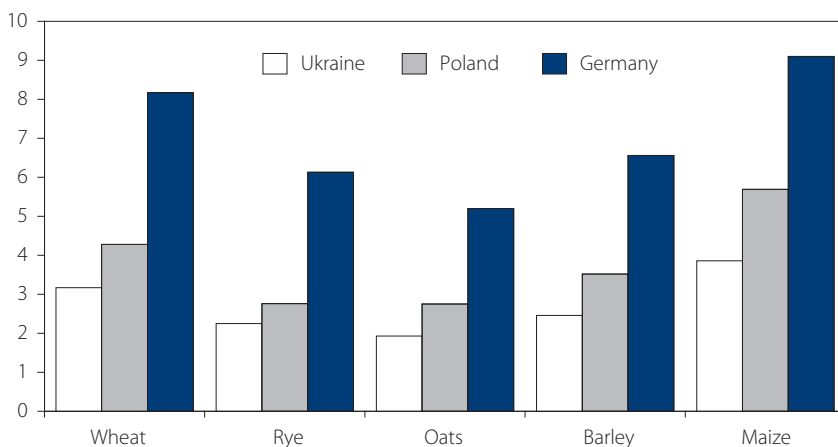
In the early 2000s, growth in the sector was achieved due to family holdings that proved to be more efficient than and fit the new market conditions better than agricultural enterprises that had replaced former collective farms. The situation changed in 2004, when agricultural enterprises' output was growing faster than that of family holdings. Moreover, only agricultural enterprises now enjoy growth in livestock farming. Growth of production in family holdings is hindered by the following factors:

- small size of farms, which limits economy of scale opportunities;
- poor financial state of enterprises;
- inadequate access to financial resources and infrastructure.

Ukraine's agricultural potential is high and underused to a great extent. In particular, its main cereal-crop yield is 3–6 t per hectare lower than in neighboring countries, whereas the sugar beet yield is 20–50 t per hectare lower.

According to specialists' estimates, Ukraine could increase its grain yield to 50–70mn t, vs 38mn t in 2005, by improving technologies, which will also enable it to increase exports of these products two- or even three-fold. The country's milk output potential is estimated at 18mn t, vs 13.8mn t in 2005.

Chart 3. Grain yields, t/ha



Source: Faostat

The main problems of agricultural development:

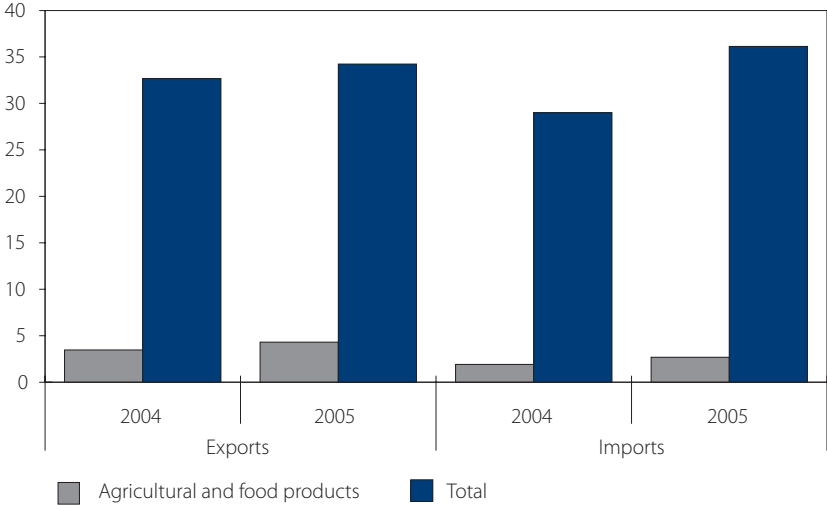
- **LACK OF FREE ACCESS TO LAND** is making it impossible to use land as a collateral for obtaining loans. The state of leasing under the the situation when free access to land is denied does not favor investments in its improvement. Finally, since there are no legal ways to sell land, various shadow schemes for its purchase and sale have been developed.
- **UNDERDEVELOPED INFRASTRUCTURE** (roads, elevators, agricultural equipment, etc.) is causing an increase in the cost of manufacturing, high losses during transportation and the storage of products.
- **POOR ACCESS TO FINANCE**, especially for family holdings, is limiting investment opportunities and improvements in production efficiency.

- **THE LACK OF SUSTAINABLE STATE POLICY FOR AGRICULTURAL DEVELOPMENT** is leading to the inefficient use of public funds allocated to agriculture. State programs for agricultural development do not contain well-defined priorities and state resources are scattered among a great number of recipients, helping nobody as a result.
- **THE LOW QUALITY OF LIVESTOCK PRODUCTS** is limiting prospects for exporting these products because Ukrainian quality standards do not meet EU ones.
- **LOW SECTOR EFFICIENCY** is caused first and foremost by the unsatisfactory quality of seed and pedigree material, as well as low labor productivity.

Trends in agricultural product trade

The Ukrainian agricultural products sector has been poorly integrated into the international trade. Taking into consideration Ukraine’s agricultural resources, trade policy plays a critical role in the future of the sector’s development. Ukraine’s integration into the WTO and later on into a free trade area with the EU is an essential condition for speeding up structural reforms in the country, as well as for its potential to become evident on international markets. Ukraine’s accession to the WTO will make it impossible to use export subsidies, whether explicit or implicit, and will likely entail a decrease in import tariffs for certain kinds of agricultural products.

Chart 4. *Ukraine’s exports and imports, billions USD*



Source: Derzhkomstat

Ukraine has considerable agricultural potential due to its vast areas of fertile soil and closeness to key markets in the Middle East, North Africa, the former USSR and, potentially, the EU. Ukraine’s food industry, which consumes raw materials produced by the domestic agriculture sector, was a driving force for the economic growth that started in 2000.

Significant liberalization of Ukraine’s agricultural market started in 1999. In particular, the practice of fixing the minimal customs value was stopped in 1999 – 2000. This used to apply to a number of goods such as meat, dairy products, grain crops, flour, vegetables and fruit. In 2000, the list of excisable

goods was shortened significantly and the customs tariffs for certain goods were lowered. Excise duty is paid on only imported ethyl alcohol, alcoholic beverages, tobacco and tobacco products. In 2005, notable changes were introduced with respect to customs tariffs for imported agricultural products, which liberalized the Ukrainian market greatly, including zero or low *ad valorem* rates for some products at the level of 5–10%. Rates of about 30% are kept for some "sensitive" goods, such as certain kinds of poultry.

Until 2005, agricultural products imported to Ukraine were, for the most part, limited by high customs tariffs and non-tariff barriers. Although in 2005, food and agricultural products imported to Ukraine equaled only 7.4% of the total volume, the growth in imports of these products was 40%, whereas total import volumes increased by 24.5%. Factors for the rapid increase in imports were the decrease in customs tariffs and the growth of private consumption.

Trade with EU countries

In 2005, Ukraine's exports of agricultural products to EU countries accounted for 20.6% of the country's total exports to the EU. This represents a 24% increase in the exports of agricultural products to the EU against 2004, whereas the total exports to this group of countries fell by 5.9%.

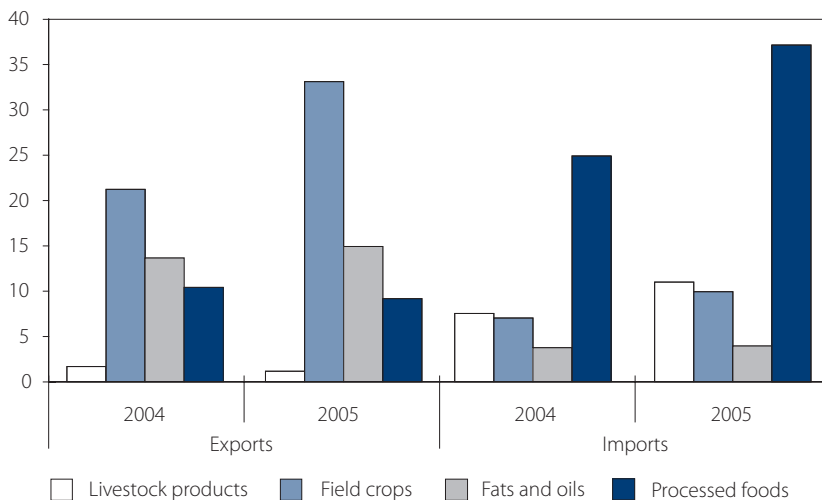
The share of agricultural products in imports from the European Union to Ukraine constituted 35.2% in 2005. This represents a 43.5% increase in the imports of agricultural products compared to 2004, whereas total imports grew by 26.6%. **In 2005, Ukraine became a net importer of agricultural products in its trade with the EU.**

In 2005, the imports of processed food products showed the greatest increase, 49.1%, while exports fell by 11.9%. The main factors behind the rapid growth in imports of these products are the decrease of import tariffs and increasing demand among Ukrainian consumers as their incomes grow. One of the factors for the decrease in exports of these products is the low competitiveness of Ukrainian goods.

The same trend has been evident in relation to trade in live animals and products of animal origin. The growth of demand on the domestic market has been an additional factor for the reduction of exports of livestock products. A ban on imports of live animals to the EU is another limiting factor for imports.

Field crops remain the main type of goods exported to the EU. Exports of such products grew 60% in 2005. Grain crops account for more than half of these exports. In 2005, exports of grain to the EU rose 90%.

Chart 5. Ukraine's trade with EU, millions USD



Source: Derzhkomstat

Trade barriers

Major barriers to Ukraine – EU trade in agricultural products include:

- undeveloped infrastructure (granaries, roads, transport);
- over-regulated and long customs procedures;
- an underdeveloped information system concerning the market and poor access to information;
- low share in the output of high-quality products (in particular, hard wheat sorts);
- failure to reimburse exporters for VAT;
- export/import duties on certain products;
- a ban on Ukrainian imports to the EU due to the inconsistency between Ukrainian standards and those of the EU.

Trade prospects under an FTA+

Grains

Since 14 November 2005, wheat has been imported to the EU duty-free. This means that Ukraine already has conditions for free trade with the EU. Since grain crops represent the main kind of agricultural products exported by Ukraine to the EU, the main limiting factor relating to the increase of the import of grain crops is the thus far comparatively low output of grain crops in Ukraine against its potential. Another factor is the discrepancy between Ukrainian and international quality and safety standards.

Possible cooperation/measures under an FTA+

Ukraine's measures	EU measures
Ensuring more stable grain crops	Free trade regime reinforcement
Increase in grain crops (increasing yields and cutting losses)	Promoting attraction of European investments for agricultural infrastructure development
Improvement of grain quality (development of new sorts, a rise in the share of higher quality grain crops)	Increase in the sales of high-quality seed, technologies and agricultural equipment to Ukraine
More flexible reaction to external market demands (development of transport, granaries, study of demand for different kinds of grain crops)	Introduction of a training program for Ukrainian farmers
Adjustment of wheat quality and safety standards to international standards	
Adoption of a state program for the increase of grain crops	
Diversification of products	
Allocation of targeted state subsidies for purchasing high-quality disease-resistant seed, technologies and farm equipment from the EU	

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian grain growers	Expansion of markets Increase in produce quality Increase in productivity Increased access to financial markets, including foreign ones	Increase in competition on certain grain markets Additional expenditures for output increase, diversification and increase in crop quality
Grain traders	Increase in incomes as a result of market expansion	
EU agricultural producers	Expansion of markets (particularly milled and hulled grain ¹⁸) as a result of the rapid growth in Ukrainian incomes	Increase in competition
Government/officials		Need for adoption of a state program for sub-sector development Cutting back opaque state expenditures as requirements for targeted financing get tougher
Ukrainian consumers/ Ukraine's economy as a whole	Increase in market supply Improvement of product quality More efficient use of public funds allocated to support agriculture	Grain crops represent a group of goods with a low value added Increase in grain crops export will not cause an increase of product exports with a high added value
European consumers/ EU economy	Increase in market supply	Increase in EU budget expenditures for technical assistance to Ukraine
Financial sector	Widening of financing availability	

Livestock

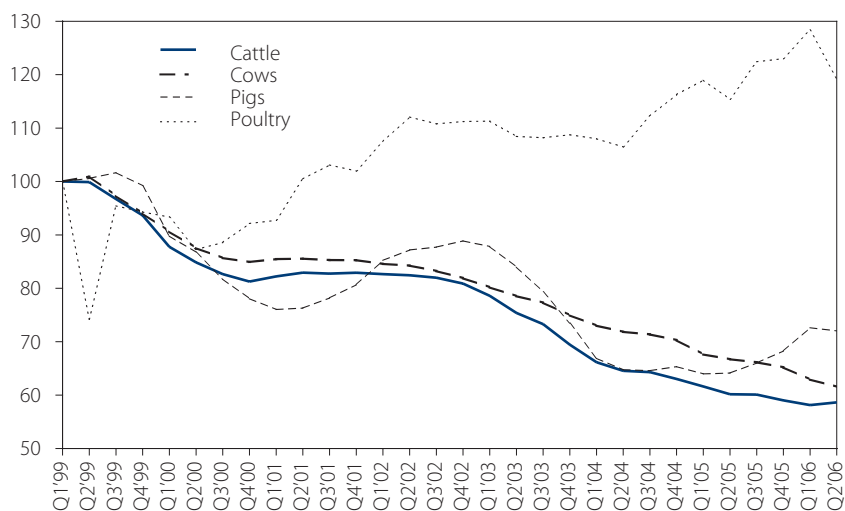
Ukraine is not included in the list of countries that have the right to export live animals and meat to the EU. The import of fresh meat, meat products, fresh game, livestock, poultry and other live animals from Ukraine to the EU is banned. Ukraine is allowed to export only live horses and donkeys to the EU.

The main obstacle for Ukrainian exports to the EU is a discrepancy in product quality standards. Only 52% of Ukrainian standards for agricultural products have currently been harmonized with international ones, while the figure for food industry is only 29%. Poultry farming is so far the only branch able to satisfy market demand, whereas the pork and beef markets are experiencing a shortage. The pig headcount revival started in H2'05. The ICPS forecast is for the decline in the cattle and cow headcount to level off in 2007.

¹⁸ In 2005, imports of these products from EU to Ukraine grew 60%.

Chart 6. Cattle and poultry headcounts

index, seasonally adjusted, Q1'99 = 100



Source: Derzhkomstat; calculations by ICPS

Poultry

Ukrainian poultry has good prospects for entering the European market if the necessary bans are lifted.

Factors determining an increase in Ukrainian poultry exports to the EU include:

- high rates of sub-sector development and domestic market saturation;
- high level of profitability, ensuring proper funds for certification and promotion on the foreign market;
- high level of branch consolidation and powerful lobby, helping to secure state aid for lobbying producers' interests and their entry into the EU market.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian producers of poultry products	Expansion of markets Increase in product quality Increase in efficiency	Increase in competition ¹⁹ Additional expenditures for output increase, certification ²⁰
EU producers of poultry products	Expansion of markets	Increase in competition
Ukrainian consumers/ Ukraine's economy as a whole	Increase in market supply Improvement in product quality Decrease in poultry prices No state expenditures in case of private investments in certification of products Expansion of exports of products with high added value	
EU consumers/ EU economy	Increase in market supply Decrease in poultry prices	

Milk and dairy products

As a result of the decrease in the cow population, milk production has grown very slowly recently. In 2005, Ukrainian milk and dairy product exports to the EU dropped by 48.8%. Development of milk and dairy product exports to the EU is being hindered by:

- the discrepancy between Ukrainian dairy product quality and EU standards;
- high domestic demand;
- high demand for Ukrainian dairy products in CIS countries, where quality requirements are less strict.

Ukraine is a net importer of dairy products in its trade with the EU. In 2005, milk and dairy product imports from the EU to Ukraine grew 60%. Dairy imports from the EU to Ukraine will continue to increase. This will be caused by two main factors:

- a stagnation in Ukraine's milk production;
- a rapid boost in Ukrainian income and the demand on the high-price segment market (for cheeses in particular).

The process of reaching quality standards and related product certification takes quite a while, so dairy product exports from Ukraine will be excluded

¹⁹ At the moment, import tariffs for poultry products constitute 10% and 30% depending on the product. Should Ukraine require free access of Ukrainian poultry products to the EU market, immediately a counter-requirement to introduce zero import tariffs will be aired.

²⁰ Taking into consideration rather high profitability in the branch and also Ukrainian poultry farmers' interest in entering the EU market, they will be able to finance certification measures needed to adjust to EU standards themselves.

from the free trade arrangement at the initial stages. Cooperation with the EU at the initial stages will be limited to carrying out EU requirements for relative quality indices. Most likely, customs tariffs for dairy imports at this stage will be preserved at the current level. At later stages, it will be possible for enterprises obtaining corresponding quality certificates to enter the EU market. The EU will require an introduction of zero customs tariffs.

Possible cooperation/measures under an FTA+

Ukraine's measures	EU measures
Elaboration of stage-by-stage plans for the introduction of EU quality standards in Ukraine (laboratories, certification)	Elaboration and introduction of a program for reforms in livestock breeding (directed towards the enlargement of agricultural enterprises in particular)
Provision of technical assistance aimed at reforming livestock breeding and introduction of laboratories to supervise sanitary and phytosanitary standards	Conclusion of an agreement allowing for the exports of products meeting EU quality requirements (within several years since the signing of the main agreement on FTA+) to the EU
	Promotion of private investments in the sub-sector aimed at reaching the quality standards needed in a timely manner
	Facilitating sales of European technologies
	Assistance to Ukrainian enterprises in their attempts to enter the European market

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian dairy makers	Increase in produce quality as a result of the boost in the number of enterprises whose products meet EU quality standards in the short run Expansion of markets in the long run Increase in production efficiency in the long run	Increase in competition as a result of a boost in imports from the EU Increase in additional expenditures for output, certification (in the short run)
EU dairy makers	Expansion of markets	Increase in competition (in the long run)
Ukrainian consumers/ Ukraine's economy as a whole	Increase in market supply Improvement of product quality Expansion of exports with a high added value in the long run	Increase in the price of dairy products if domestic producers' competitiveness decreases Increase in state expenditures for certification needs
Government/ officials	Approval of state decisions/introduction of policies that meet European standards	Need for elaboration of relative regulatory norms Cutting opaque state expenditures
EU consumers/ EU economy	Increase in market supply, decrease in prices in the long run	Increase in expenditures for technical assistance to Ukraine (for the country to meet quality standards)

The sugar industry

The sugar market will most likely remain protected within the framework of agreements concluded with the WTO. Ukraine will keep its market closed to sugar imports because of powerful interest groups that protect the domestic production of sugar and sugar beets. In order to preserve symmetry, the EU will probably keep its market closed to Ukrainian sugar, too. However, even if the European market were open, Ukrainian sugar produced mainly from sugar beets would be uncompetitive in terms of price compared to cane sugar.

Fruit and vegetable farming

In Ukraine, commercial fruit and vegetable farming has considerable prospects, including the possibility of raising export potential. In 2005, Ukraine was a net exporter of vegetables, roots, edible fruits and nuts in its trade with the EU. Exports of these two groups of goods rose by 53% in 2005. However, the growth rate for the imports of these products used to be much higher, having reached 173%.

The domestic demand for fruit and vegetables will grow rapidly in the near future. As their incomes increase, Ukrainians tend to eat more healthy food, causing a rise in the consumption of fruits and vegetables. On the other hand, a rather swift restructuring of retail trade is taking place in Ukraine at the moment, especially in the rise of retail chains. Simultaneously, there has been a drop in the share of the retail trade market. The increasing number of chains will mean a rise in the demand for fresh, homogeneous fruit and vegetables.

Thus, the demand for high-quality fruits and vegetables is growing and only efficient agricultural enterprises are currently able to satisfy it. The development of farming for big retail chains will also have a multiplying effect on the country's economy and will be reflected through the establishment of warehousing centers, whose task will be to eliminate the need for dealers between producers and retailers in order to provide consumers with fresh produce.

Possible cooperation/measures under an FTA+

Ukraine's measures	EU measures
Establishing labs to provide agricultural enterprises with seed material ²¹ and supervise sanitary and phyto-sanitary standards	Provision of technical assistance to reform the sub-sector and the introduction of labs to supervise sanitary and phyto-sanitary standards, as well as quality standards
Introduction of a state program for the development of fruit and vegetable cultivation in Ukraine	Promotion of the expanded sale of seeds and technologies
Provision of targeted subsidies to sub-sector enterprises	

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian fruit and vegetable growers	Expansion of markets Increase in produce quality Increase in productivity	Increase in competition Additional expenditures for certification
Dealers		Decrease in number of intermediators between producers and sellers
EU fruit and vegetable growers	Expansion of markets	Increase in competition
Ukrainian consumers/ Ukraine's economy as a whole	Increase in market supply Improvement of produce quality Decrease in produce prices Development of related production and services (retail trade, logistics)	Increase in state expenditures for setting up labs
EU consumers/ EU economy	Increase in market supply Decrease in produce prices	Increase in state expenditures for technical assistance to Ukraine

²¹ Taking into account a quick increase in imports of these products, state aid will be of great importance at the initial stages of developing fruit and vegetable growing.

Reforming food safety and quality regulation

The current situation

Ukraine's organizational and legislative foundation for the regulation of food and food ingredient safety and quality has not undergone essential transformations since the fall of the Soviet Union. The current system serves state control agencies rather than public interest, a situation that has resulted from the weak involvement of stakeholders in drafting standard acts to regulate the system.

The inefficient regulatory system is not capable of responding to new challenges, including:

- environmental changes;
- scientific progress;
- foreign trade and globalization;
- computerization and the internet;
- the development of biotechnologies.

Taking these processes into account, the most developed countries are paying a great amount of attention to reforming regulatory systems for food and food ingredient safety and quality. Without an effective regulatory system, Ukrainian food products will be unable to compete on international markets and in the framework of an FTA+, Ukrainian food will continue to have limited access to the EU market.

Ukraine's food-processing industry has entered a phase of rapid growth, spurred by full use of capacities that were inherited from soviet times. Competition has also grown significantly. Enterprises have been forced to diversify their products, introduce new technologies and enter new markets in order to survive. An effective system for the regulation of food safety and quality is needed to sustain this process. On one hand, such a system should protect consumers from food dangerous to their health and also guarantee accurate information about nutritional value. On the other hand, it should enable producers to receive confirmation on the safety and quality of their products at low cost. It seems impossible to reach these goals without substantial changes in legislation and the organizational provision of a system for the regulation of food safety and quality.

In 2000, the European Union started large-scale reform of the state system for the control of food products. On 29 April 2004, five EU legislative acts that regulated food safety issues were simultaneously adopted. These regulations

meet more complicated requirements on the protection of consumer health and interests and as well as economic development. Obviously, Ukraine should follow EU practice if it desires EU integration.

The majority of provisions in EU food legislation are based on provisions of the WTO Agreement on the Application of Sanitary and Phyto-Sanitary Measures (the SPS Agreement). Para. 2 of Art. 2 declares: "Members shall ensure that any sanitary or phyto-sanitary measure is applied only to the extent necessary to protect human, animal or plant life or health, is based on scientific principles and is not maintained without sufficient scientific evidence." Taking into account WTO member countries' experience, Ukraine's inappropriate application of this article could cause additional difficulties in promulgating Ukrainian products on external markets.

According to experts, there is a growing trend towards additional state control measures over enterprises that work in the agricultural sector, instead of improving existing measures or replacing inefficient measures with efficient ones. Ukraine's current food control system:

- has no clear organizational structure, which leads to function duplication by different control bodies, additional barriers for enterprises, the inefficient use of Budget funds, and a lack of coordination;
- has no system for assessing control bodies' performance and efficiency; and
- is a financial and organizational burden for enterprises forced to pay at least twice for state control, firstly, to the State Budget through taxes, and secondly, to these control bodies directly or other organizations that work with them.

The food control system is not only a drag on development in the sector, but also may become an insurmountable barrier to the export of food. EU provisions on official food control set out a new, complicated procedure for agricultural products admitted in the European Union. Thus, the export of Ukrainian food to the EU will only be permitted on the condition that there exists an official control system in Ukraine able to ensure a level of consumer protection equivalent to that in EU.

Because of all this, the EU market will unlikely be open to Ukrainian food within the framework of an FTA+ unless the country's regulatory bodies are reformed and approaches to making and implementing state policy are changed to reflect the protection of consumer health and interests. Negative developments are also a possibility in the area of trade with other developed countries that are reforming their regulatory systems according to the same principles.

SPS in the WTO and in EU FTAs

Sanitary and phyto-sanitary standards (SPS) are drawing increasingly more attention within the framework of international trade. SPS control measures are designed to prevent any harm imports could cause to consumer health and safety. At the same time, restrictions imposed in order to achieve national safety standards could be abused as a means of protectionism. The WTO primarily concerns itself with tariffs, which serve as traditional instruments of protectionism. However, international agreements on SPS are aimed at finding a balance between national standards for product safety and fair market access.

The WTO agreement on SPS contains a set of key provisions. First, member countries are free **to choose the level of protection they find appropriate** and also to set out measures to achieve a target level of protection. Second, the agreement's **harmonization** requirement envisages that national standards be based on standards approved and recommended by international organizations. Any stricter measure has to be grounded on scientific **risk assessment**. Third, an **equivalence principle** is recommended for various measures that achieve a similar protection level. An exporting country must demonstrate that its measures are equivalent to those in the importing country. Bilateral and multilateral agreements known as "equivalence agreements" or "mutual recognition agreements" provide institutional frameworks for equivalence. Such agreements offer a basis for the interchange of information on standards, certification recognition, and provisions on repeated testing, appeal and the return of rejected products.

Other important provisions refer to a **regionalization concept** envisaging that safety identification must take note of regional peculiarities, particularly regional diseases, or control programs set up in certain regions.²²

Finally, procedural provisions deal with transparency issues, particularly requirements envisaging the introduction of ways to formulate inquiries and informing.

Bilateral agreements are for the most part focused on procedural issues, whereas the WTO establishes the basis for stipulating norms and standards. Free trade agreements with the EU usually foresee provisions designated to make the introduction of WTO provisions on SPS easier. These can be done through:

- 1) the step-by-step introduction of SPS measures foreseen by the WTO;
- 2) harmonization, which means compliance with WTO standards and mutual recognitions of provisions.

²² This concept is especially crucial for Ukraine in the aftermath of the Chornobyl disaster.

Provisions on SPS usually cover the following aspects in free trade agreements:

- recognition of agreements on SPS with the WTO;
- cooperation on SPS issues;
- harmonization of standards as an ultimate aim; and
- clear provisions on technical assistance on SPS issues.

Beyond WTO provisions, free trade agreements may, for instance, refer to such aspects as:

- provisions or amendments on particular products;
- establishment of a joint management committee;
- a process of equivalence recognition worked out in detail;
- methodology for verification, import checks and certification;
- a timetable and provisions on internal accountability and consultations;
- requirements on data exchange;
- provisions recognizing specific establishments without prior inspection.

SPS provisions in FTAs between the EU and other countries

EU–Chile

The EU–Chile Association Agreement contains Annex IV on sanitary and phyto-sanitary measures relating to trade in animals, animal products, plants, plant products and other goods, as well as animal protection. With this agreement, the signatory parties confirmed their rights and commitments stipulated in the WTO agreement. Provisions of the agreement cover trade in the kinds of products mentioned in the annex. The main provisions of the agreement set out:

- procedures for defining equivalence: corresponding provisions require substantial cooperation between both sides' relevant institutions;
- procedures of certification and verification;
- procedures for checking out imports and paying for inspection;
- procedures for data interchange, informing and consultations with the indication of deadlines and a way of submitting information relating to SPS issues;
- establishment and functioning of the Joint Management Committee whose objective is to supervise the introduction of the agreement and deal with all the questions relating to the agreement, as well as to assess the issues that may arise in connection with the introduction.

EU–Mexico

The EU–Mexico Global Agreement does not contain any provisions that go beyond commitments within the framework of the WTO. The most important provisions of EU–Mexico cooperation on SPS issues are enshrined in the EC/Mexico Joint Council Decision 2/2000. This Decision stipulates the procedures to be followed by a special committee, consisting of four members (two representatives from each side) and is obligated to:

- ensure discussions to define and work on problems that may arise in connection with applying certain measures;
- initiate the elaboration of special provisions to introduce regionalization or to assess equivalency; and
- initiate elaboration of specific measures to exchange information.

Table 3. *Inconsistency between Ukrainian and EU legislation requirements, practices and their application*

Issue	Ukraine's legislation and its application	EU legislation and its application
Principles for the development of food legislation	Ukraine's legislation does not stipulate for these principles	Principles are stipulated for by EU Regulation №178/2002 of the European Parliament and the Council of 28 January 2002
Responsibility for ensuring food safety and consumer interests	Ukrainian food legislation does not set up clear distribution of responsibility. Both de facto and de jure the state bears the main responsibility for ensuring food safety. However, it has not got sufficient resources, first of all financial	EU legislation foresees that food market operators find themselves in the most favorable conditions to work out a safe system for supplying food and ensuring that it is safe; thus, the main responsibility for product safety must rest on them
Financial and organizational framework for carrying out thorough research in the field of food safety ensuring	Ukrainian legislation creates neither organizational nor financial basis for carrying out thorough research in the field of ensuring food safety	Legislative basis for ensuring science-based information with further decision-making in the fields where food legislation is effective has been elaborated
Regulation of breaches of law	In fact, Ukrainian food legislation applies a general intent principle vesting state controls bodies' officials with an authority to decide whether an enterprise is an infringer and also to impose a fine upon this enterprise or apply other types of punishment	EU tries to reach a balance of public interests concerning protection of, on the one hand, consumers' health and interests and, on the other hand, interests of food market operators. In particular, a "due diligence" principle is applied, according to which an operator can be free from responsibility if he proves he did his best to fulfill legislative requirements

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Issue	Ukraine's legislation and its application	EU legislation and its application
Legislation stability	The number of administrative services, i.e. services provided by corresponding bodies and mandatory for operators in accordance with legislative requirements, is constantly growing at the level of laws and other norms	Weighted approach to reimbursement of operators' expenses for kinds of activity envisaged by food legislation. The majority of expenses for these activities (primarily standard official control) are covered with State Budget funds. Usually operators pay only for the kinds of administrative services that do not concern all food market operators. For instance, for carrying out additional official control measures in case violation of the law has been observed during the standard official control
Delimitation of authority	Ukrainian food legislation does not provide for a clear delimitation of authority among control bodies, neither principles nor mechanisms to manage control system has been defined at the national level	EU Member States are establishing or have already founded united bodies responsible for control over all food products (from fields to retail enterprises). EU Regulation №882/2004 of the European Parliament and the Council from 29 April 2004 set out clear principles and mechanisms to manage national systems of food control
Legislative review	Ukraine's legislation envisages no foundations for introduction of transparent principles and mechanisms of drafting and reviewing food legislation acts. The Law "On main principles of the state regulatory policy in the field of economic activity" could solve this problem. However, sanitary measures have been excluded from the purview of this law	Legislative underground has been created and mechanisms for elaboration, evaluation and review of food legislation acts have been introduced in such a way that public discussion on these acts with all stakeholders or through unions representing them is ensured, except in circumstances when a proviso principle needs to be applied
Introduction of new products	Coordination of regulatory documents for any products planned to be produced serially	Coordination of regulatory documents and obtaining a permit for placing in the market only those products falling under the category "latest." In other words, these are products whose ingredients or processing technology have not yet been widely represented in the market. Production of any other food products is possible without obtaining a permit or coordination of regulatory documents. For instance, not more than a few dozens of "latest" products are registered in the European Union yearly

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Issue	Ukraine's legislation and its application	EU legislation and its application
Sanitation and epidemiological review	Mandatory sanitation and epidemiological review	There is no such a notion
Product certification	Mandatory certification of products with over 30 days shelf-life	No such certification system. Mandatory certification is applied for export-import operations only
Veterinary certificates	Mandatory veterinary certificates for all animal product lots	Mandatory inspection of live animals before slaughter and carcasses after slaughter. Mandatory obtaining of a veterinary document for processed products of animal origin for domestic market is not usually foreseen
A proper national control plan	No such a requirement	Imposition of requirements relating to drafting a national control plan and annual reporting on its carrying out
Availability of a quality management system	No analogous requirements, although Ukraine has approved a state standard that is believed to be a copy of ISO 17025	A requirement relating to have an ISO 17025-based quality management system in laboratories as a condition of carrying out tests for official control purposes. World experience shows that laboratories cannot carry out tests with an acceptable level of reliability without such QMS

Ways of reforming the system

In order to succeed in raising the quality of goods, a system of control over food quality and safety within the framework of an FTA+ needs to be reformed through the adjustment of standards envisaging the protection of health and interests of those living in Ukraine. This can be achieved by:

- harmonization of food legislation acts with provisions enshrined in documents of the corresponding international and national organizations, and as well as the European Union's legislation;
- provision of scientific information for making decisions in the fields where food legislation is effective, in particular risk assessment and communications in this respect;
- decision-making within the purview of food legislation relating to food safety on the basis of risk analysis, except under circumstances where a warning needs to be applied;
- a result-oriented and effective official control system that meets market economy principles and makes it possible to remove barriers for Ukrainian exports to developed countries worldwide; and
- a balance between consumer health and interests and the interests of retailers.

Food safety and quality control system must be based on six principles:²³

- **COMPREHENSIVENESS AND INTEGRATION.** A comprehensive and integrated approach “from field to table” within the whole food cycle should be applied when setting out requirements for objects and subjects of regulation, as well as during the planning, implementation and management of control measures.
- **DIVISION OF RESPONSIBILITY FOR ENSURING PRODUCT SAFETY AND PROPERLY INFORMING CONSUMERS.** The main responsibility for ensuring food safety as well as properly informing consumers rests on operators as far as operations with food, accompanying materials and objects and animals are concerned. The state is responsible for:
 - drafting and adopting of corresponding legislation;
 - implementing risk analysis;
 - taking necessary measures to prevent or eliminate risk, as well as to bring the industry up to par; and
 - organizing official control in order to verify operators' implementation requirements in food legislation and taking measures if there is a need for action against these operators.
- **TAKING RISK ANALYSIS AS A BASIS.** In order to reach a general goal, like a high level of health protection, food legislation requirements relating to the safety of food, accompanying materials and objects, animal health must be based on risk analysis, except in cases when this does not correspond to the circumstances or character of a measure. Risk analysis must be based on existing scientific evidence and carried out in an independent, objective and transparent manner.
- **APPLICATION OF WARNINGS IN APPROPRIATE CIRCUMSTANCES.** In some cases, when evaluation of the data available and the possibility of a harmful effect on human and/or animal and/or plant health is identified and there exists a scientific uncertainty about this effect's likelihood and severity, temporary measures to manage the risk may be taken until complete scientific information for risk evaluation is provided. These measures have to be adequate and must not exceed the appropriate level of human, animal and plant health protection, i.e. they cannot be too restrictive for operators, produce, animals or plants. The measures should be reviewed right after new scientific data concerning the issue are obtained or during a period of time sufficient for analyzing the results of measures taken for risk management.

²³ Adapted from the Explanatory note to the Bill “On main principles of food legislation and official enforcement.”

- **TRANSPARENCY.** Elaboration, evaluation and review of food legislation acts should be carried out in a manner that ensures the public discussion of these acts by all stakeholders or through associations representing them, except under circumstances in which a warning needs to be applied, such as when consumer health is threatened and there is still not enough scientific information to make substantial decisions. If there exist well-founded reasons to suspect food may be dangerous to human or animal health and they do not contradict legislative provisions on access to information applied in Ukraine, corresponding executive bodies should note the degree of severity of these risks and take adequate steps to inform the public about the nature of the risks, describe the food or animals in detail, the risk they might constitute and measures being taken or steps to be taken in order to prevent, reduce or eliminate such a risk.
- **TAKING INTERNATIONAL STANDARDS, INSTRUCTIONS AND RECOMMENDATIONS AS A BASIS.** In case international standards, instructions and recommendations already exist or their adoption is anticipated, their requirements should be taken into account while elaborating food legislation acts, except in cases when these documents or their corresponding parts would be ineffective or inefficient measures to reach food legislation goals, or if there are scientific grounds proving they would lead to a protection level different from the one stipulated as appropriate in Ukraine.

Reforming the regulatory system

Public consultations have revealed that interest groups do not see an urgent need to set up a single designated authority to manage the official control system and carry out its own official control. Instead, solving the following problems seems more important:

- raising the effectiveness, efficiency and transparency of official control;
- eliminating unreasonable obstacles for business activity in order to ensure food safety, as well as the safety of specific quality indicators.

Laboratory testing

Laboratory examination of products is an issue for an official control body. The new system of quality control should ensure an acceptable level of the authenticity of the test results that are used in deciding if products meet food legislation demands.

EU experience affirms the importance of reference laboratories in ensuring scientific and technical support. An institute for this purpose needs to be introduced in Ukraine within the next few years. Its goal would be to provide sci-

entific and methodical support to official laboratories, particularly concerning the application of analytical methods, organize comparative tests, coordinate research into new analytical methods, conduct trainings for lab personnel and provide technical support for a specially designated system of food control.

SPS control measures

Ukraine's acceding to the WTO will become an important step in the development of SPS control because then Ukraine will be obliged to follow key WTO provisions on SPS. Ukraine's membership in the WTO will probably bring to light the most sensitive points of the issue. Work on a Ukraine – EU free trade area should be focused on the facilitation and introduction of WTO provisions on SPS. In our opinion, it is mandatory that the future agreement contain provisions on cooperation with respect to SPS issues and lay out the harmonization of standards as an ultimate goal.

Since the Ukrainian control system is complicated enough, it will also be important to specify the process of equivalency recognition. The existence of such a provision would stimulate the process of reforming the Ukrainian control system as far as the addition of such a provision to the agreement would induce Ukraine to prove that its control system is able to ensure the level of food safety required by the EU.

Possible cooperation/measures under an FTA+

Reforming the control system

Ukraine's measures

Adoption of the relevant legislative basis with discrepancy elimination

EU measures

Provision of advisory assistance in order to create a control system equivalent to that one existing in EU
Control over compliance of the control system operation to EU requirements

Setting up and operating laboratories

Ukraine's measures

Adoption of the relevant legislative basis
Drafting a plan for introduction of reference-laboratories
Ensuring budget financing for creation and functioning of laboratories

EU measures

Provision of advisory assistance in order to create a system of laboratories
Provision of technical assistance for training personnel

Impact on stakeholders

We believe reforming a system for the state regulation of food safety and quality will affect stakeholders thus:

1. **STATE BODIES PRESENTLY ENSURING STATE REGULATION OF FOOD SAFETY AND QUALITY.** We expect reaction to reform to be negative since a more effective system will reduce posts and powers. Most likely, this is the very interest group that will resist attempts to start the reform.
2. **UKRAINIAN FOOD PRODUCERS.** This interest group's reaction might be ambiguous. Producers have succeeded in adapting to the current system despite all its inefficiency, meaning any attempts to reform the control system could cause producers to negatively react since the additional burden of the reform will be theirs to bear at its initial stages. However, an effective and transparent system will mean improvement of the business environment in the country, which will lead to a reduction in producers' direct and indirect costs. In order to diminish possible negative consequences of reform, the state will have to launch a large-scale information campaign, as well as ensure the adoption of comprehensible normative acts.
3. **UKRAINIAN SOCIETY AS A WHOLE.** A more effective control system will have positive consequences for Ukrainian society as a whole as far as:
 - a decrease in public expenditures for ensuring such control;
 - an improvement in the business environment and a decrease in producers' both direct and indirect costs;
 - the efficiency and operation of creation of such a control system will be equal to that of the EU, making it easier for Ukrainian food producers to enter the European market and improving Ukraine's balance of trade.
4. **EUROPEAN UNION.** We expect the EU to support Ukraine in its aspiration to reform its control system since increasing its efficiency would lead to reaching possible goals of a future FTA + . A system that meets EU quality control principles will facilitate a decision on expanded access of Ukrainian food to the EU market. At the same time, a more transparent control system would favor the inflow of European investment into Ukrainian agricultural enterprises.



Machine-building,
chemical and light
industries

Although the machine-building, chemical and light industries are showing positive growth trends, they are largely dependent on external market dynamics. Orienting on external demand can lead to positive short-term results, but it is not a suitable basis for an industrial development strategy. On the other hand, the deep free trade formula being proposed by the EU, which involves dropping customs duties and cutting back non-tariff restrictions, such as through the unification of product standards, could be the foundation for such a strategy.

This section looks at the current state of three industrial sectors and their development prospects in the context of a Deep Free Trade Agreement:

- *machine-building (trends in this sector determine the country's overall level of economic development and growth potential);*
- *the chemicals industry (the key supplier for most of Ukraine's economic sectors); and*
- *light industry (globally, trade in these industries has been completely liberalized).*

Although an FTA+ bears significant short-term risks for these sectors, in the medium and long term the impact of deep free trade with the EU will be positive.

A brief overview of the sectors

Machine-building

The current situation

In recent years, the share of machine-building in overall industrial output has been steadily growing, with output increasing the fastest in the industry. Despite this, production at machine-building enterprises is still operating at only 50–65% of capacity on average.

The state of the machine-building complex is not uniform. Some highly-evolved production has entered foreign markets, while other production is depressed. There are many reasons for the difference in the economic standing of sub-sectors, mainly related to differences in the situation and dynamics of markets for machine-building products.

One of **the factors pushing the sector's expansion** is growing demand for heavy machinery among both foreign companies working in Ukraine and domestic enterprises. In the last year, domestic demand has risen because of a need to upgrade fixed assets and introduce energy-saving technologies. In addition, rising investment demand, growing personal incomes and expanded consumer lending have spurred sales of passenger cars and household appliances.

Table 4. *Trends in machine-building*

Positive	Negative
<ul style="list-style-type: none">• Moderate pick-up on domestic market as a result of more active consumer lending• More active investment in the country• Price a major competitive edge• Abandonment of most forms of state aid that contradict international rules and Ukraine's commitments	<ul style="list-style-type: none">• Underdeveloped domestic market, low purchasing power among customers• Underutilization of production capacities• Declining productivity• Outdated technology• Lack of resources for a comprehensive overhaul of production• Lack of common standards• Competition from imports from EU countries

Foreign trade

Over 2000–2004, the share of machine-building products in total export commodities grew significantly. Despite a slight decline in 2005, the upward trend renewed itself in 2006, to 12.1% in January 2006, 13.5% in Q1'06 and 14.4% in H1'06. Even in 2005, machine-building accounted for 13.5% of export commodities, coming second only to exports of metal products, at about the same level as exports of mineral products (see **CHART 1.1** in **APPENDIX 1**).

Over 2000–2005, the share of machine-building products in total import commodities grew steadily. Over January–June 2006, machine-building accounted for almost 29% of imported goods (see **CHART 1.3** in **APPENDIX 1**). Such figures are evidence that Ukrainian enterprises are already beginning to modernize and are buying up-to-date imported equipment. These statistics also confirm that there is lively investment in the Ukrainian economy.

According to Eurostat data (see **TABLE 1.1** in **APPENDIX 1**), imports prevail in trade in machine-building products with the EU. Over 2001–2005, these imports grew 120%, while Ukrainian exports of machine-building products to the EU remain a small, if gradually rising, part of total exports and comparatively small volumes. At the moment, the EU-25 is the biggest trading partner for the domestic machine-building sector.

State aid

State aid is considered to have a negative impact on the efficiency of resource use, to impede free competition and to be a threat to the consolidation of the European Union market. In Ukraine, machine-building is subsidized in a variety of ways, **both through direct sector-oriented support and indirect subsidies** such as tax exemptions and tax deferments.²⁴

Table 5. *Laws governing sector programs supporting machine-building*

Sector	Legal base	Expected validity	Exemptions provided
Shipbuilding	Law №1242–XIV “On measures related to government support for the shipbuilding industry in Ukraine” of 18 November 1999	01.01.2001 – 01.01.2005	Excise duty, state financial support through discounted loans
Aircraft construction	Law №2660–III “On state support to the aircraft construction industry in Ukraine” of 12 July 2001	01.01.2002 – 01.01.2007	Excise duty
Car-making	Law №535/97–VR “On incentives for car-making in Ukraine” (as amended and expanded) of 19 September 1997 Law №1624–IV “On the development of the car-making industry” of 18 March 2004	01.01.2002 – 01.01.2007 Up to 01.01.2008 Up to 31.12.2008	Import duty
Aerospace	Law №1559–III “On state support for space activity” of 16 March 2000	Up to 01.01.2009	Excise duty

Source: Government Support for Producers in Ukraine: Reforms According to the WTO and EU Norms, Ukrainian Center for International Integration, Kyiv, 2004.

²⁴ The drawbacks of indirect subsidies are that, as a rule, they are not reflected in official Budget documents, are not transparent and offer incentives for greater corruption.

Incidentally, although both EU and WTO norms allow tax exemptions to companies, there are certain restrictions on their application. In the EU, the use of tax exemptions is allowed in support of investment projects, but it cannot be applied to cover operational expenses of companies, that is, **to subsidize day-to-day commercial activity**.

A reduced tax regime was available to such priority sectors as car-making, shipbuilding, aircraft construction, and space industry. The list of companies in each of the priority sectors that were eligible for state aid was approved by the Cabinet of Ministers and the support itself was regulated by specific temporary legislation (see **TABLE 5**).

Producers were exempted from import duty, land tax, the VAT, and excise duty. However, the majority of these tax exemptions was revised and cancelled by the Law "On the 2005 State Budget."

Chemicals

The current situation

Over 2000 – 2003, the chemical industry's share of value-added in GDP shrank from 2.5% to 2.1%. The same downward trend can be observed in the ratio of value-added to output. This is clear evidence of the **insufficient level of restructuring in the sector**.

Chemical products have **high production costs**. On the whole, many companies in this sector are in a poor financial state: a significant number are unprofitable, with overall profitability a paltry 5%. However, over 2005 – 2006, positive trends appeared in the chemical industry and performance indicators began to rise. This was mainly because of a favorable situation with world prices for chemical products.

Table 6. *Trends in the chemical industry*

Positive	Negative
<ul style="list-style-type: none"> • State aid policy that approximates international standards 	<ul style="list-style-type: none"> • Foreign trade based mostly on unfinished and low-end products (60% on average) • Underdeveloped processing industry in the chemical sector • A low level of equipping and technology • A flawed system of protection for domestic producers • High production costs • A low ratio of certified products

Foreign trade

In 2005, chemicals accounted for 10.4% of export commodities and nearly 14% of import commodities (see **CHART 1.2** in **APPENDIX 1**). Exports are typically dominated by semi-finished and low-end products (about 60% on average). The sector's level of low equipping and technology is generally low, as is the proportion of certified products.

In trade in chemical products with the EU, exports are on the rise, while the share of chemical products in total exports to the EU is in decline, and imports are showing rapid growth. Over 2001 – 2005, imports doubled (see **TABLE 1.2** in **APPENDIX 1**), although domestic chemical manufacturers are currently facing a number of anti-dumping probes initiated by the EU.²⁵

State aid

Until 2003, chemical enterprises enjoyed a reduction in their corporate profit tax if they invested in fixed assets. Over 2002 – 2003, deliveries of all medications and goods for medical purposes were exempted from the VAT. In 2004, such exemptions were significantly cut back by the State Budget Law. In 2003, the government provided direct compensation to chemical enterprises. To prevent price pressure on medications, the Cabinet of Ministers introduced²⁶ a scheme for compensating pharmaceutical companies losses related to an increase in excise duty rate for ethyl alcohol using simple bills of exchange in 2004.

In short, most state aid for chemical industry was in the form of tax mechanisms, primarily to protect the pharmaceutical industry. With time, state aid shifted emphasis and a portion of tax exemptions gradually gave way to more targeted assistance, such as a professional support program.

The termination of subsidization programs was a sign of positive changes in government policy. It showed a shift to gradual leveling of the commercial playing field across all sectors of the economy and bringing policy more in line with to international standards.

²⁵ For example, the European Commission established a final anti-dumping duty for potash of EUR 19.61 – 48.19/t in 1992 and for carbamide from EUR 8.85/t to EUR 16.84/t in 2002.

²⁶ The 30 December 2003 Cabinet of Ministers Resolution №2077 "On approving the Procedure for compensating commercial producers for excess expenditures in 2004 related to the increased excise duty rate for ethyl alcohol used to produce medications effective as of 1 January 2004." This was dropped in 2005.

Light industry

The current situation

The importance of the domestic light industry has been declining over time, as evident in the fact that its share in overall industrial output has shrunk eight-fold, from 10.8% in 1990 to 1.2% in 2003. Over 2004 – 2006, this figure stabilized at around 1.0 – 1.1%.

Ukraine's light industry consists of more than 10,000 enterprises, including about 800 large and medium companies, forming a multi-sector complex that covers the full cycle of interrelated production. Moreover, small enterprises have developed significantly in this sector and account for almost two-thirds of the total number of companies, 99% of which belong to the private sector.

The ratio of value-added to output is on the upswing. This suggests a positive restructuring in the sector, better technologies and the replacement of labor-intensive production as a result of fierce competition with foreign manufacturers.

Table 7. *Trends in light industry*

Positive	Negative
<ul style="list-style-type: none">• Positive restructuring• Rationalized state support	<ul style="list-style-type: none">• Strong dependence on getting raw materials through tolling schemes• Illegal imports to Ukraine

Foreign trade

In 2005, this sector had only a 3.6% share of export commodities and 5% of import commodities (see **CHARTS 1.1** and **1.2** in **APPENDIX 1**). Moreover, its share of EU trade has been steadily shrinking (see **TABLE 1.3** in **APPENDIX 1**).

The major factor in the garment industry is **strong dependence on getting raw materials through tolling schemes**. Indeed, production using imported textiles outpaces production using Ukrainian textiles by 30%.

A major problem across light industries is the domination of **contraband goods and goods manufactured in the shadow economy** on the domestic market. This sector needs structural improvements and conditions for production to be vertically integrated with the help of foreign investment, an expansion of wholesale and brand retail chains, incentives for small enterprises, and measures to legitimize the manufacture and sale of its products.

According to Art. 21 of the Partnership and Cooperation Agreement between Ukraine and the EU, trade in textiles and clothing is regulated by a separate agreement—**the Agreement on Trade in Textile Products between Ukraine and the EU**. The cancellation of quotas for textile goods in the EU made it possible to increase Ukrainian exports to the European Union and to keep jobs.

State aid

Over 2002 – 2004, light industry companies received state subsidies only in the form of tax incentives, including tax exemptions and tax benefits for enterprises located in SEZs and TPDs. At the moment, tax exemptions have been dropped due to the elimination of SEZs and TPDs. In terms of the domestic trade, no major changes are anticipated as regards support for this sector.

EU industrial policy in these sectors

To anticipate what kinds of provisions related to the machine-building, chemical and light industries might be included in a future Free Trade Agreement with the EU, it is important to understand trends in common industrial policy in the EU, new approaches to the way the EU implements it, and key aspects of industrial development in the EU.

The latest trends in EU industrial policy²⁷

1. **RELOCATION OF PRODUCTION FROM THE EU TO COUNTRIES WITH LOWER PRODUCTION COSTS** has not become widespread. However, it does pose a potential threat to EU labor markets, especially unskilled labor. Still, it is clear that the EU's new industrial policy²⁸ acknowledges the reality of production relocation (that is directly related to FDI and, therefore, of interest to Ukraine). Thanks to its favorable economic and geographic position and low production cost, Ukraine could become an outsourcing region for EU manufacturers.
2. **PROTECTION OF INTELLECTUAL PROPERTY RIGHTS AND COMBATING COUNTERFEITS** through stronger policies is becoming one of the key elements in EU competitiveness. This could result in growing pressure on partner countries, including Ukraine, to combat counterfeit products and piracy and to protect domestic trademarks. In a Free Trade Agreement with the EU, Ukraine could face strict EU requirements related to the country's commitments in protecting intellectual property rights.
3. **THE LAUNCH OF AN EU PROGRAM TO SIMPLIFY LEGISLATION** in 2005. Simplifying and raising the quality of legislation was identified as a challenge in a broad range of sectors, including construction, car-making, communications, and food processing. This move could potentially have a positive impact on the process of adapting domestic legislation to EU legislation.
4. **ACTIVE SUPPORT FOR STRUCTURAL TRANSFORMATIONS IN PRIVATE BUSINESS.** The EU's Structural Funds and similar instruments among Member States should be channeled in this direction. In the EU, steel-casting, leather-processing, textile, furniture, and printing industries, car-making, shipbuilding, shoe-making, ceramics, and part of the food industry all are in need of structural change. The European Commission plans to include the prepara-

²⁷ *Recent Trends in European Industrial Policy* by Olha A. Usenko, *Ukrainian Journal of Business Law*, №5, 2006.

²⁸ "Implementing the Community Lisbon Programme: A policy framework to strengthen EU manufacturing—Towards a more integrated approach for industrial policy" (COM(2005) 474).

tion for change and managing transformations in the Structural Fund's new programs for 2007 – 2013. Preparation for structural change will include reforming labor markets and strengthening regional development. In terms of strengthening bilateral cooperation through an FTA+, Ukraine could receive related technical assistance.

5. **SERIOUS ATTENTION TO THE ISSUE OF ACCESS TO MARKETS.** This EU strategy includes revising existing mechanisms and instruments to concentrate on sectors and markets that have the biggest potential in terms of competitiveness. Together with interest groups, analysts will develop and implement a strategy for accessing markets in specific countries. Notably, the development of market access instruments could result in new requirements of countries like Ukraine, when negotiating an FTA.
6. **A COMPREHENSIVE APPROACH TO SUPPORT FOR RESEARCH AND INNOVATIONS.** The EU's strategy includes special initiatives for a number of sectors. The European Technology Platforms are expected to contribute to growing investment in innovation. These Platforms have already proved effective in forming policy for the hi-tech industry. In terms of European integration, Ukraine is facing a very ambitious challenge—to work out spheres of scientific and technological cooperation.

EU industrial policy by sector

Machine-building

Machine-building accounts for **about one-third of value-added in EU industries**. This sector is growing at a medium to rapid pace and investing strongly in research.

Key trends in this sector include:

- growing protection of intellectual property rights;
- greater attention to innovation issues;
- problems with pollution;
- continuous revision of technical standards.

For machine-building, one extremely important issue is access to international markets, especially in telecommunications, electro-mechanical equipment, and cars.

Car-making

Until 1992, the EU passenger car market was segmented by various internal barriers and had no unified approach to regulating trade with third countries.

The internal EU market had a combination of customs duties that started at 10% for the common external duty and free trade areas with restrictions on import volumes from specific countries.²⁹ In 2003, Western Europe accounted for 95% of the EU's car output and 31.4% of global car output.

The issue of protecting the domestic market has shifted to the issue of limited access for EU exporters to other markets. These restrictions were the result of trade-related investment measures: requirements as to the share of domestic output, components, tax exemptions for manufacturers, and strategic programs for internal investment in specific sectors.

The problems and prospects of the EU car industry are presented in the form of SWOT³⁰ analysis here.

Table 8. *SWOT-analysis of car-making in the EU*

S	<ul style="list-style-type: none"> • A competitive market and demanding consumers, which spurs innovation • Leadership in technology and infrastructure • Innovative and good quality products that are customer friendly • Presence on markets in both developed and developing economies • Leadership in manufacturing trucks and buses • Effective state policy
W	<ul style="list-style-type: none"> • Competition with Japanese makers, which could cut into the market share of European makers • Less oriented towards consumers than, say, the US car industry • Dominated by a relatively small number of small companies, mainly suppliers, which makes them potential targets for take-overs
O	<ul style="list-style-type: none"> • Potential leadership in new technologies • Strong positions on the huge Chinese market • Room to increase economies of scale and increase investment activity through deeper cooperation • Growing external demand for trucks and buses • Potential for a retail system for manufacturing parts and components that is oriented on consumers • Exports of related services, such as design and engineering • High likelihood of gaining access to new markets by establishing production chains
T	<ul style="list-style-type: none"> • Shrinking market share because of the weak financial state of some commodity producers • Losing the technological edge, especially in parts and components • Strong competition on the part of Japanese and American makers • Relocation of production to countries with lower production costs

Source: Trends and Drivers of Change in the European Automotive Industry: Mapping Report by the European Foundation for the Improvement of Living and Working Conditions, 2004.

²⁹ For example, Italy has limited imports of cars to 2,300 since 1986, France to 3% of the domestic market since 1981, and the UK to 11% of the domestic market since 1977. These kinds of restrictions have been explicitly discriminatory against cars imported from Japan. In 1992, the EU introduced voluntary restrictions on exports against Japanese imports. These were in effect until 1999. Since then, the EU has applied a 9% import duty on imports of passenger cars.

³⁰ SWOT = Strengths, Weaknesses, Opportunities, and Threats.

Shipbuilding

Global shipbuilding is unusually concentrated, with Japan, South Korea, China, and the EU accounting for 90% of global output. Since the Asian crisis of 1997, the EU's share has been shrinking steadily, going from 19% in 2000 to 7% in 2003.³¹

In nearly all EU Member States, the shipbuilding sector consists of one or two large enterprises, with the remainder mainly small and mid-sized shipyards. Traditional protectionist instruments are fairly limited in the shipbuilding industry as the sector is, for all intents and purposes, not subject to the WTO's anti-dumping and anti-subsidy rules.³²

The EU has developed a new instrument for protecting trade from unfair pricing in shipbuilding that is similar to anti-dumping measures. It consists of additional payments by shipbuilders, based on the level of adjudicated unfair differential. When a shipbuilder fails to make this payment, the EU can prohibit the company's vessels from loading and unloading at EU ports. However, the institution of this instrument has been postponed in expectation of an OECD Agreement Respecting Normal Competitive Conditions in the Commercial Shipbuilding and Repair Industry and the ratification of this Agreement by the US.

Starting in the early 1970s, support for this sector was regulated by seven directives that each amended the previous one. The seventh directive, which was extended annually until September 1996, aimed at channeling state aid, which was limited to 9% of total aid given to the machine building sector. Aid had to be directed only into building those types of vessels that might make EU shipyards more competitive. Since 31 December 2000, shipbuilding has been subject to **the same rules of state aid as apply to other industries**. The types of state aid allowed in shipbuilding include:

- support for innovation and R&D;
- environmental protection;
- partial or full closure of companies;
- support for restructuring;
- regional support.

The European Commission has focused its efforts on increasing the competitiveness of EU shipbuilders through **incentives for research and support for industrial cooperation**.

³¹ *EU Trade Policy* by O. I. Shnyrkov, Kyiv, 2005.

³² Commercial vessels are transferred into use directly at shipyards, so there is no physical delivery or customs clearance. That is, ships are not imported on traditional terms. Moreover, there is little serial production. Most ships are made to order for a specific customer.

Chemicals

Despite the fact that the EU is among global leaders in chemical products, its share of global output has been showing a gradual decline.

In terms of added value, the chemical industry is one of the main industrial sectors among the EU-15. Chemical companies are key suppliers to all sectors of the economy. Some 30% of chemical products are further processed in the industry. A number of trends can be seen in this sector:

- slow growth of demand in Europe and high demand in Asia, especially China;
- the threat of growing exports of cheap products from Russia;
- ever more imports of chemicals, especially finished products, to Europe, which affects prices and the financial performance of chemical manufacturers in the EU;
- relocation of production;
- high production costs;³³
- energy-intensive production requires more environmental efforts³⁴ and the installation of energy-saving technologies.

In turn, these negative trends are leading to:

- declining interest among investors to put capital into this sector;
- shrinking R&D budgets;
- depreciating technology.

Because of its energy intensity—the chemicals industry consumes about 12% of EU energy—, **stable access to fuels** is a fundamental factor to support the EU industry's competitiveness.

Despite liberalizing its energy market, energy prices remain higher in the EU than in other regions. Since trade in chemical products depends on competitiveness and the availability of **reliable logistics**. Delivery costs are, on average, 8% to 10% of total working capital among chemical companies.³⁵

Currently, the EU's transport infrastructure is fairly overloaded in key industrial regions. This means that the Union needs to improve delivery channels and logistical systems in order to optimize operation in this sector. On 29 October 2003, a new regulatory base—a common system for registration, evalu-

³³ Energy prices in Western Europe are five times higher than in Russia and three times higher than in Ukraine.

³⁴ In the EU-15, spending on environmental protection is EUR 7.7bn per annum on average. This accounts for about 23% of environmental costs for the entire industry of the EU-15.

³⁵ Delivery costs are 13% higher in Europe than in the US.

ation, authorization, and restriction of chemical substances (REACH)—was introduced, to replace 40 directives and regulations.³⁶

Some 25% of the EU's chemical products are exported to third country markets. The conclusion of a Chemical Tariff Harmonization Agreement (CTHA) during the Uruguay Round of trade talks, most OECD countries now have low import duties.

Light industry (e.g., textiles, clothing and footwear)

Light industry, particularly textiles and footwear, accounts for 8% of total added value in EU industries. With low or negative growth, the sector needs:

- more spending on research;
- structural reforms;
- greater innovation and protection of intellectual property;
- better access to global markets.

The EU is the biggest global importer of textiles and clothing and an exporter of textile products, rated second in the world for exported apparel. In terms of output and employment, this sub-sector plays a more important role in the economies of the new EU Member States (the EU-10) than in the EU-15. Exports of textiles and apparel from the EU-10 mostly go to the EU-15, ranging from 66% to 100%, depending on the country and the product.

For a long time, the EU protected internal producers from imports from third countries. In addition to unilateral measures, it actively used **bilateral agreements** and the **multilateral Multi-Fiber Arrangement Regarding International Trade in Textiles (MFA, the Agreement on International Trade in Cotton Textiles of the GATT)**. Under the MFA, the EU was allowed to use restrictive quotas, particularly as part of a voluntary restriction on exports based on relevant bilateral agreements for four – five years. However, the Agreement on Textile and Clothing signed as part of the Uruguay Round gradually removed these restrictions by 2005. Over 1994 – 2005, the EU gradually doubled the size of quotas for WTO member countries.³⁷

At the moment, the EU common trade policy in textiles and clothing is focused on opening non-European markets and providing incentives for exports from

³⁶ The purpose of the REACH system is to ensure a high level of protection for human health and the environment while having a domestic market that operates efficiently. It is also expected to provide incentives for investment and growing competitiveness in this sector.

³⁷ From the mid-1990s to the mid-2000s, the EU carried out a policy of acclimatizing domestic producers in this sector to new competitive realities on the Internal Market by: reducing the number of quotas and increasing their size; strengthening protection of intellectual property rights; improving education, training and employment; expanding SME access to loans; orienting regional funds towards supporting textile makers; encouraging R&D; and expanding access to third country markets.

the EU. Special attention should be paid to developing international specializations for specific kinds of products, keeping current competitive advantages on the European continent. For example, the Pan-European system of diagonal cumulation of origin of goods should make it possible to more efficiently locate various stages of the production cycle. Interestingly, programs to gradual cut back production capacities have found support in the EU in recent years.

Sample bilateral agreements with the EU

Central European (CE) countries integrated into the EU on the basis of Association Agreements. This led to inflows of FDI as a way to include CE countries in the EU production chain. Whereas the share of internal sectoral trade³⁸ with the EU Member States in overall CE country trade was only 10 – 15% in the early 1990s, by the beginning of 2000s, this had risen to nearly 60%.

As can be seen in Art. 72, "Industrial cooperation," of the bilateral Agreement between the EU and Poland, the Agreement primarily establishes mechanisms for building a market economy and forming a favorable business environment in Poland.

The EU–Poland³⁹

Art. 72.

Industrial cooperation

1. Industrial cooperation shall include:
 - (a) industrial cooperation between economic operators in the Community and in Poland, with the specific aim of strengthening the private sector;
 - (b) Community participation in Poland's efforts in both the public and private sectors to modernize and restructure its industry, which will effect the transition from a centrally planned system to a market economy under conditions that ensure that the environment is protected;
 - (c) the restructuring of individual sectors; and
 - (d) the establishment of new undertakings in areas offering potential for growth.
2. Industrial cooperation initiatives shall take into account priorities determined by Poland. The initiatives should seek in particular to establish a suitable framework for undertakings, to improve management know-how, and to promote transparency as regards markets and conditions for undertakings.

In the Association Agreement with Chile, there is a provision for promoting industrial cooperation projects and establishing forms of infrastructure that will be stimulated by European investment.

³⁸ The share of internal sector trade reflects the degree of integration of a country into regional production chains.

³⁹ The Agreement Establishing an Association between the European Communities and their Member States, of the one part, and the Republic of Poland, of the other part.

The EU–Chile⁴⁰ (1)

Art. 17.

Industrial cooperation

1. Industrial cooperation will support and promote industrial policy measures to develop and consolidate the Parties' efforts and establish a dynamic, integrated and decentralized approach to managing industrial cooperation, so as to create a favorable environment to serve their mutual interests.
2. The central aims will be:
 - (a) to boost contacts between the Parties' economic operators, with the aim of identifying sectors of mutual interest, especially in the area of industrial cooperation, transfers of technology, trade, and investment;
 - (b) to strengthen and promote dialog and exchanges of experience between networks of European and Chilean economic operators;
 - (c) to promote industrial cooperation projects, including projects deriving from the process of privatization and/or the opening-up of the Chilean economy; these could cover the establishment of forms of infrastructure stimulated by European investment through industrial cooperation between businesses; and
 - (d) to strengthen innovation, diversification, modernization, development, and product quality in businesses.

Across the world, it is becoming more common that the technological factor in development cannot be applied effectively because of cross-border restrictions. The concepts of "integration" and "joint projects" have many points of intersection. Thus, implementing joint projects can spur the integration of certain sectors, while comprehensive integration can and is being called upon to facilitate more active formation of joint projects. The Agreement with Chile has an entire article that pays exceptional attention to identifying specific forms of cooperation between the parties.

The EU–Chile (2)

Art. 36.

Cooperation in science and technology

1. The aims of cooperation in science and technology, carried out in the mutual interest of both Parties and in compliance with their policies, particularly as regards the rules for use of intellectual property resulting from research, shall be:
 - (a) policy dialog and exchanges of scientific and technological information and experience at the regional level, particularly in respect of policies and programs;
 - (b) promotion of long-term relations between the two Parties' scientific communities; and
 - (c) intensification of activities to promote linkage, innovation and technology transfer between Chilean and European partners.

⁴⁰ The Agreement Establishing an Association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part.

2. Special emphasis will be put on human potential building as the real long-lasting basis for scientific and technological excellence and the creation of permanent links between both scientific and technological communities, at both national and regional levels.
3. The following forms of cooperation should be encouraged:
 - (a) joint applied research projects in areas of common interest, with active participation of business undertakings where appropriate;
 - (b) exchanges of researchers to promote project preparation, high-level training and research;
 - (c) joint scientific meetings aimed at fostering exchanges of information and interaction and at identifying areas for joint research;
 - (d) the promotion of activities linked to prospective scientific and technological studies which contribute to the long-term development of both Parties; and
 - (e) the development of links between the public and private sectors.
4. Furthermore, the evaluation of joint work and the dissemination of results will be promoted.
5. Higher-education institutions, research centers and productive sectors, including SMEs, on both sides shall be involved in this cooperation in an appropriate manner.
6. The Parties shall promote their respective entities' participation in their respective scientific and technological programs in pursuit of mutually beneficial scientific excellence and in accordance with their respective provisions governing the participation of legal entities from third countries.

According to Art. 76 of this Agreement, all import or export prohibitions or restrictions in trade between the Parties, other than customs duties and taxes, whether effected through quotas, import or export licenses or other measures, shall be eliminated upon the entry into force of this Agreement. No such new measures are supposed to be introduced.

It is worth noting the Agreement with Chile governs an issue like simplifying access to its market through an increase in mutual recognition, understanding and compatibility regarding the given systems of both parties.

The EU–Chile (3)

Art. 87.

Specific actions to be pursued under this Agreement

With a view to fulfilling the objective of this section:

1. The Parties shall intensify their bilateral cooperation in the field of standards, technical regulations and conformity assessment with a view to facilitating access to their respective markets, by increasing the mutual knowledge, understanding and compatibility of their respective systems.
2. In their bilateral cooperation, the Parties shall aim at identifying which mechanisms or combination of mechanisms are the most appropriate for particular problems or sectors. Such mechanisms include aspects of regulatory cooperation, *inter alia*, convergence and/or equivalence of technical regulations and standards, alignment

to international standards, reliance on the supplier's declaration of conformity, and the use of accreditation to qualify conformity assessment bodies, and mutual recognition agreements.

3. Based on progress made in their bilateral cooperation, the Parties shall agree on what specific arrangements should be concluded with a view to implementing the mechanisms identified.
4. To this end, the Parties shall work towards:
 - (a) developing common views on good regulatory practices, including, but not limited to:
 - (i) transparency in the preparation, adoption and application of technical regulations, standards and conformity assessment procedures;
 - (ii) necessity and proportionality of regulatory measures and related conformity assessment procedures, including the use of supplier's declaration of conformity;
 - (iii) the use of international standards as a basis for technical regulations, except when such international standards would be an ineffective or inappropriate means for the fulfillment of the legitimate objectives pursued;
 - (iv) enforcement of technical regulations and market surveillance activities;
 - (v) the necessary technical infrastructure, in terms of metrology, standardization, testing, certification, and accreditation to support technical regulations; and
 - (vi) mechanisms and methods for reviewing technical regulations and conformity assessment procedures;
 - (b) reinforcement of regulatory cooperation through, for example, exchange of information, experiences and data, and also through scientific and technical cooperation with a view to improving the quality and level of their technical regulations and making efficient use of regulatory resources;
 - (c) compatibility and/or equivalence of their respective technical regulations, standards and conformity assessment procedures;
 - (d) promotion and encouragement of bilateral cooperation between their respective organizations, public and/or private, responsible for metrology, standardization, testing, certification, and accreditation;
 - (e) promotion and encouragement of full participation in international standard-setting bodies, and re-inforcement of the role of international standards as a basis for technical regulations; and
 - (f) expansion of their bilateral cooperation in the relevant international organizations and forums that deal with the issues covered by this section.

Possible cooperation and measures under an FTA+

Measures undertaken by Ukraine and EU under FTA+

Sector	Measures undertaken by Ukraine	Measures undertaken by the EU
Machine-building	<p>Instituting international standards and technical requirements/harmonizing Ukrainian legislation with EU legislation</p> <p>Developing and implementing a plan for adapting domestic commodity producers to external competition</p> <p>Providing incentives for joint research activity</p> <p>Establishing conditions to attract EU institutions and commercial structures to participate jointly in international hi-tech projects (rocket and space production, aircraft construction, shipbuilding, energy equipment, bio-technologies)</p> <p>Developing a national program for commercializing scientific developments along with the necessary mechanisms for attracting financial resources and running a large-scale information campaign</p>	<p>Deepening cooperation with Ukraine as one of the areas for more active innovation</p> <p>Supporting the commercialization of Ukrainian scientific developments</p> <p>Providing technical assistance for instituting EU standards</p>
Chemicals	<p>Developing a program for commercializing inventions, especially in energy conservation</p> <p>Involving foreign contractors in modernizing and building infrastructure, and optimizing logistical systems</p>	<p>Helping attract financial resources to modernize and develop Ukraine's pipeline infrastructure</p> <p>Providing technical assistance for the certification of Ukrainian products</p>
Light industry	<p>Providing state incentives for developing business in this sector, through easier access to financial resources</p> <p>Arranging cooperation with European commodity producers</p> <p>Taking steps to bring the manufacture and sale of products out of the shadows</p>	<p>Cooperating with Ukrainian companies</p>

The FTA+ impact on industry

Despite definite short-term risks for such industrial sectors as machine-building, chemicals and light industry, the institution of an FTA + between Ukraine and the EU will have a positive impact on the country's entire economy in the medium and long term. Ukrainian companies will gain access to EU markets, provided that they meet EU standards and regulatory requirements. Meanwhile, the cost of instituting EU standards and re-equipping production facilities should be compensated through an inflow of investment capital from the EU. This should provide incentives to reorganize and upgrade enterprises, foster new production and increase State Budget revenues.

The trend towards re-locating production from the EU to countries with lower production costs—as happened with Central European countries—should enable Ukraine to be linked to EU production chains and to increase its role in the European and global division of labor. A more competitive business environment should also have a positive impact on the conditions under which Ukrainian companies work within the FTA + . The arrival of quality EU products with a strong consumer orientation on the Ukrainian market should provide incentive to improve the quality of domestic products and have an overall positive impact on Ukrainian consumers.

One of the most important issues for businesses—greater access to financial resources—could be partly resolved by reducing interest rates for commercial loans through a more active presence of foreign banks on the domestic market.

In the short term, there is a risk of saturating Ukraine's domestic market with consumer-oriented imported goods, which could lead to a situation where small enterprises will lose market share and even have to shut down. This is particularly likely in the light industry, where the proportion of small companies is high. The same is true of varnish-and-paint products and high-end chemical products.

All this points to the need to institute an asymmetric FTA that can ensure optimal transition mechanisms for adjusting domestic manufacturers to stronger outside competition.

With those state aid practices that contradicted international and European standards having largely been cancelled in the researched sectors, policy in this area can be rationalized with the institution of an FTA + . Apart from its specific content, an FTA + should open the door to joint projects with Ukraine in such potentially profitable and well-developed fields as aircraft construction, the space industry and energy-saving technologies.

Ukraine should identify priority areas of scientific and technological cooperation with the EU, based on the available scientific potential, such as the National Academy of Sciences, and on the level of interest and financial capacity on the EU side regarding specific areas for this kind of interaction.

In Ukraine, rising prices for Russian natural gas spurred the active development of energy-saving technologies, while in the EU, it focused attention on the security of energy deliveries from Eurasian countries, especially Russia. More active cooperation could involve the EU in financing the construction of transport infrastructure and the development of energy-saving products.

Undoubtedly, the cost of adjusting national legislation to EU legislation will be high and the lack of the any prospects for actual membership means Ukraine will be ineligible for EU subsidies. Given this, one of the key conceptual principles of the proposed model for integrating into an FTA+ is a selective and flexible adoption of the *acquis*. This is particularly true of such burdensome and extremely costly EU norms as the social bloc of the *acquis* and environmental protection standards.

Analysis according to stakeholders

Stakeholder	Pros	Cons
The economy as a whole	<ul style="list-style-type: none"> More favorable conditions for investing in Ukrainian industry Growing FDI, greater use of production capacities New jobs and growing State Budget revenues Modernization of the economy Participation in the EU division of labor The institution, at least selectively, of high standards of environmental protection 	<ul style="list-style-type: none"> Bankruptcies of commodity producers not capable of competing with foreign companies
Consumers	<ul style="list-style-type: none"> Lower prices for traditionally high-quality EU consumer products Better quality of domestic products The likelihood of lower prices for domestic products 	
European business	<ul style="list-style-type: none"> The option of relocating production to a region with a potentially large internal market and relatively low labor costs, which could have a positive impact on the price competitiveness of EU products Access to a new market through the production chain 	<ul style="list-style-type: none"> Insufficient well-informed workers regarding various production processes should companies relocate to the regions The cost of raising the professional qualifications of employees

>> continued

Stakeholder	Pros	Cons
Ukrainian business	<p>Freer access to the EU market</p> <p>The inflow of EU investment</p> <p>Greater utilization of production capacities, modernization and reorganization of companies</p> <p>Access to new technologies, comprehensive revamping of production</p> <p>The possibility to be included in the European production and supply chains (the creation of production chains)</p> <p>Accumulation of non-price parameters of competitiveness of domestic products through stronger external competitive pressure</p> <p>Sliding rates for bank loans through enlivening operation of foreign banks on the domestic market, which will provide a better access to financial resources</p>	<p>A domestic market saturated with imports</p> <p>High external competitive pressure causing the bankruptcy or loss of control business among SMEs. (This is especially true of light industry, where such companies constitute the overwhelming majority)</p> <p>Unreadiness to meet the requirements of EU technical regulations in the short term</p> <p>The cost of instituting EU standards and re-equipping</p> <p>Energy consumption of current production and technological obsolescence spurring the replacement of equipment production with the production of component parts for foreign companies</p>
The Government	<p>Rationalized state support policy</p> <p>The option of a flexible, selective approach to the adoption of the <i>acquis</i></p> <p>The development and institution of effective market surveillance over product safety based on market practice</p> <p>Expanding opportunities for financing joint scientific projects, especially in aircraft construction, the space industry, and energy-saving technologies</p> <p>EU involvement in financing infrastructure for the uninterrupted supply of energy to Europe</p>	<p>The cost of harmonizing legislation and bringing the national standards in line with international norms, especially the protection of intellectual property rights, the social bloc of the <i>acquis</i> and standards for environmental protection</p>



Financial services

The conclusion of the Deep Free Trade Agreement between Ukraine and the EU will make it possible to not only eliminate restrictions on the movement of capital and labor (in the future), but also restrictions on all types of services, including financial services.

Free trade in financial services will have a significant, positive impact on the Ukrainian economy as a whole. Deep free trade in financial services should help:

- *improve access of the Ukrainian economy to the European capital, primarily to foreign direct investment;*
- *raise the level of corporate governance and the quality of services;*
- *increase transparency on the financial services markets; and*
- *facilitate the entry of Ukrainian business into the EU markets of financial services eventually.*

On the macro-economic side, accelerating economic growth, structural changes and increased economic stability against external challenges will ensue from deep free trade between Ukraine and the EU.

A brief overview of the financial services market

The banking sector

The most important indicators that reflect the development of the financial sector are the capital and assets of financial market operators. The development of the capital base of banking institutions is a priority area for strengthening the financial sector, enhancing its competitiveness and making it capable of entering foreign financial markets.

Growing capital reduces the risks of the financial sector, which helps raise credit ratings and, thus, lower the cost of resources in the banking system and the economy as a whole.

The dynamic of capital growth in the banking system is positive. From 1 January 2003 to 1 July 2006, the regulatory capital of the banking system more than tripled, while the total assets of the banking system nearly quadrupled.

During this period, the regulatory capital adequacy ratio (H2) was constantly above 14%, which is much higher than the requirements of the Basel Committee on Banking Supervision and the National Bank of Ukraine.⁴¹ This value of the H2 indicator is proof of a sufficiently high level of the capital coverage of risks in fulfilling the obligations faced by the country's banking system and is a positive signal for investors.

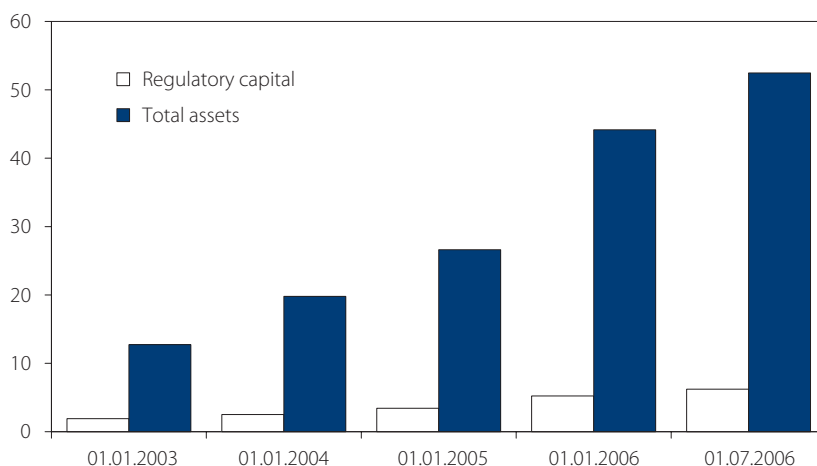
The rapid growth of assets in the banking system was seen after the quick development of the resource base of banks. As of 1 July 2006, their liabilities grew almost 320% against 1 January 2003. Funds of non-residents began playing an increasingly important role in the development of the resource base of banks—their share has significantly grown even in the environment of the rapid nominal growth of bank liabilities.⁴²

⁴¹ The Basel Committee established the minimum acceptable share of regulatory capital in risk-weighted assets at 8%, while the minimum value of the regulatory capital adequacy ratio (H2) of the National Bank was established at 10%, starting 1 March 2004. The above-average value of the regulatory capital adequacy ratio for small banks and the below-average value of the regulatory capital adequacy ratio for big banks are typical in Ukraine's banking system.

⁴² As of 1 July 2006, the share of non-residents' funds grew to 17.7% of bank liabilities against 11.1% as of 1 January 2003. During this period, nominal funds of non-residents grew 570% and were secured mainly with syndicated loans and bonds.

Chart 7. Capital and assets of the banking system

billions USD



Source: The National Bank of Ukraine; calculations by ICPS

The growing share of non-residents' funds in bank liabilities is evidence of the gradual strengthening of connections between the Ukrainian banking system and the global financial system. The share of foreign funds in the formation of capital in the banking system is even greater.⁴³

Despite the positive dynamic in the main indicators of the banking system, the level of the system's development continues to be extremely weak compared to leading world powers. As of 1 July 2006, the size of the total bank regulatory capital was slightly above US \$6bn, while total assets in the banking system constituted approximately US \$52bn. Thus, the total capital of the entire banking system in Ukraine does not exceed the size of the capital of an average Western European bank. The processes of a further increase in and the consolidation of capital and assets in the banking sector must be administered through:

- full-fledged integration into the global markets of financial services;
- legislative norms;⁴⁴
- support for macro-economic stability; and
- shrinking the shadow sector of the economy.

⁴³ As of 1 January 2007, non-residents accounted for 28% of statutory capital in Ukrainian banks.

⁴⁴ According to the instructions on the procedure for regulating bank activities in Ukraine, effective 1 January 2007, the minimum size of regulatory capital must constitute: EUR 1.5mn for local cooperative banks, EUR 5mn for regional banks and EUR 8mn for banks carrying out activities on the entire territory of Ukraine. A bill amending the law on banks and banking provides for the establishment of the minimum size of regulatory capital at EUR 5mn, regardless of the type of a bank.

The stock market

In general, Ukraine has a rather developed infrastructure and the necessary institutions for full-fledged operation of its stock market. The dynamic of trading on the stock market is growing at a rapid pace.⁴⁵ However, there is a number of legal problems that are impeding the development of the stock market to its full potential.

As of 1 January 2006, the country registered 33,754 joint-stock companies, including almost 22,000 companies in the form of closed joint-stock companies and only 11,000 companies in the form of open joint-stock companies. This means that the assets of almost two-thirds of the top Ukrainian companies cannot be an object of trade on the stock market.

The law on joint-stock companies provides for the elimination of the form of closed joint-stock companies and the reorganization of the existing joint-stock companies into open joint-stock companies. This is an important step—when implemented, it will lay the way to the stock market for funds comparable to the total value of assets that are currently circulating on the stock market.

Deeper changes in the banking system are envisaged by a bill amending the law on banks and banking. According to the law, the only organizational and legal form for the operation of banking institutions is that of open joint-stock companies, which provides for the reorganizing and eliminating of not only closed joint-stock companies in the banking system, but also that of limited liability companies.⁴⁶

The lack of clear mechanisms ensuring a transparent structure of property and the protection of minority shareholders' rights, and also preventing the use of schemes for diluting company assets in favor of large shareholders, significantly lowers the investment appeal of domestic stock instruments. Changes envisaged by the above bills must have a positive impact on the solution of these problems. Specifically, the bill on joint-stock companies identifies the following rights of small shareholders:

- the indispensable participation of minority shareholders in the supervisory councils of joint-stock companies;
- the priority right to purchase company shares in the instance of an additional issue;
- a guarantee for paying dividends that are not lower than 15% of the profits.

⁴⁵ The total volume of trading on the Ukrainian stock market was UAH 321bn in 2004 against UAH 203bn in 2003 and UAH 39bn in 2000.

⁴⁶ Out of the 165 banking institutions operating in Ukraine, only 89 were organized in the form of open joint-stock companies, whereas 42 of them were organized in the form of closed joint-stock companies and 34 of them in the form of limited liability companies.

The insurance market

The insurance market is an important component of the financial services market. The role of the insurance sector on the financial markets has a particular importance in the following context: in addition to the provision of actual insurance services, insurance companies are powerful sources of resources for the stock market and for the banking sector. In early 2006, almost 50% of insurance companies' assets were invested in shares and another 25% were invested in the banking system.⁴⁷

In recent years, the development of the insurance market has been following contradictory trends. On one hand, the capital of insurance companies grew significantly in 2004 – 2005. The volume of insurance companies' paid-up, statutory funds grew almost 90% from 1 January 2004 to 1 January 2006.

On the other, the fight against grey schemes involving the withdrawal of capital abroad through re-insurance revealed that a large portion of insurance companies was involved in carrying out dubious operations and that they were being used as instruments in money laundering. The 2005 ban on using such schemes resulted in a significant decline in insurance premiums, assets and the reserves of insurance companies⁴⁸ and put a brake on the rapid growth of the insurance services market by way of dirty capital.⁴⁹

The source of the sound growth of the insurance services market should be classically transparent types of insurance, such as life insurance, vehicle insurance, etc.

In Ukraine, life insurance accounted for a mere 2.5% of gross insurance premiums in 2005, while, in developed economies across the world, this type of insurance is a key source of revenue.

There is potential for developing the insurance market through the segment of non-government, pension insurance. Global practice shows that private pension funds accumulate huge financial resources. In 2001, global assets of pension funds constituted USD 11,484bn and were invested mainly into the US, the UK, Japan and the EU Member States.

⁴⁷ According to the State Commission for the Regulation of Financial Services Markets, as of 1 January 2006, shares accounted for 46.6% of insurer companies' assets and bank deposits accounted for 25.1% of their assets.

⁴⁸ Gross insurance premiums constituted UAH 12.9bn in 2005 against UAH 19.4bn in 2004. The size of assets determined according to Art. 31 of the Law "On insurance" shrank from UAH 17.5bn in 2004 to UAH 12.4bn in 2005, while the number of insurance reserves fell from UAH 8.3bn in 2004 to UAH 5bn in 2005.

⁴⁹ Gross insurance premiums shrank by UAH 6.6bn primarily in the sector of insuring financial risks (by UAH 5bn). The share of re-insurance in gross insurance premiums shrank to 47% in 2005 (with non-residents to 5%) against 59% in 2003 (with non-residents to 35%).

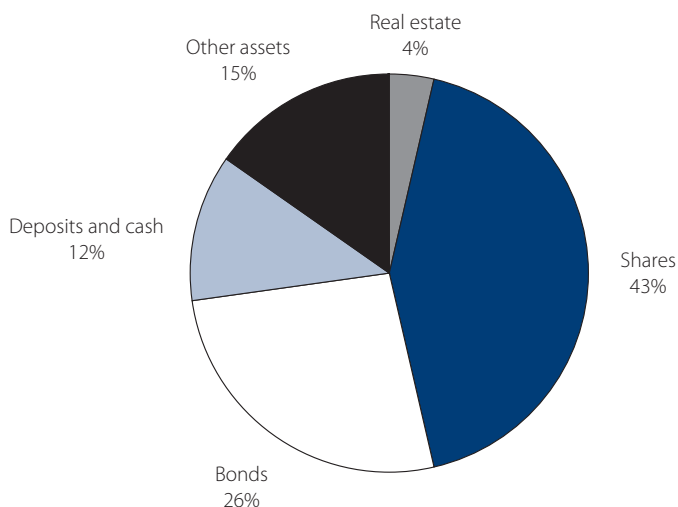
Table 9. *Gross insurance premiums in world powers in terms of insurance services, 2001*

Country	Insurance premiums, excluding life insurance, billions USD	Life insurance premiums, billions USD	The share of life insurance premiums, %	Total premiums, billions USD
US	460.4	443.4	49.0	904.0
Japan	89.1	356.7	80.0	445.8
UK	65.7	152.7	69.9	218.4
Germany	68.1	55.6	44.9	123.7
France	38.4	75.1	66.1	113.6
Italy	27.5	41.5	60.1	69.0
South Korea	14.1	36.4	72.1	50.5
Canada	24.3	21.0	46.4	45.3
The Netherlands	15.7	21.5	57.8	37.2
Spain	17.1	19.4	53.3	36.4

Source: Swiss Re, *sigma*, №6/2002

An analysis of the structure of pension-fund assets reveals that a large portion of their funds is invested in shares that constitute an essential resource of the stock market.

Chart 8. *Investment assets of global pension funds, 2001*



Source: State Commission for the Regulation of Financial Services Markets

At the moment, Ukraine is not using such a powerful source as non-government pension funds for developing the insurance and stock markets. As of 1 October 2005, the State Commission for the Regulation of Financial Services

Markets registered 48 non-government pension funds whose total assets constituted UAH 33.8mn—something that has practically no influence on any processes in the economy at the macro-economic level. About 77% of pension-fund assets were invested in deposits, practically transforming pension funds into intermediaries between investors and banking institutions without meeting the goals of private pension funds.

Non-government pension insurance needs to fulfill an important social function and its development must be a priority for the government. The development of non-government pension insurance, among other things, requires:

- the creation of an effective surveillance system;
- the creation of a fund for guaranteeing personal deposits in non-government pension institutions; and
- a public awareness campaign to explain the advantages of alternative pension security to the population.

Current efforts to institute free trade in financial services

The goal of Ukraine's integration with the EU is the institution of deep free trade. Implementation of this goal requires achieving a number of intermediary goals, one of the most significant of which is Ukraine's accession to the WTO. Ukraine signed protocols on mutual access to the markets of goods and services with the overwhelming majority of countries that are members of the WTO Working Party and adjusted a large portion of its legislation to WTO requirements, opening the possibility for rapid accession to the organization.

A number of steps that enhance Ukraine's readiness to begin deep free trade with the EU are being taken as part of the Ukraine – EU Action Plan, one of the main documents that identifies the key areas for cooperation to enhance the integration processes in terms of political, economic, cultural and security relations.

Among other things, the plan provides for a number of measures aimed at intensifying cooperation between Ukraine and the EU in the provision of financial services and measures that are related to the free movement of capital or have a serious impact on the financial services market.

Directly in terms of financial service provision, the plan provides for:

- complying with the recommendations of the IMF's Financial Sector Assessment Program (FSAP) of November 2003;

- putting into place and ensuring the effective implementation of a prudential regulatory framework for financial markets and supervision equivalent to that existing in the EU;
- ensuring effective implementation of independent and well-trained supervisory authorities in accordance with internationally recognized standards;
- securing and ensuring the effective implementation of an adequate company law, accounting and governance rules.

The plan provides for the following measures related to the movement of capital and current payments:

- ensuring the free movement of capital relating to direct investments or other investments made in accordance with provisions of Art. 48.3 of the Partnership and Cooperation Agreement on not negatively affecting conditions;
- guaranteeing the protection of foreign investments against the liquidation or repatriation of these investments and any profits therefrom;
- holding consultations on the goal of the liberalization of other capital movements in line with Art. 48.4 of the PCA.

A number of other measures with broader influence, including financial services, provides for:

- further advancing in the gradual approximation of basic legislative and regulatory framework to that of the EU, and ensuring its effective implementation;
- improving the investment climate, including by ensuring transparency and predictability;
- strengthening the independence of the National Bank of Ukraine including, if necessary, by amending the law dealing with it in order to bring it in line with EU standards;
- strengthening banking regulation and supervision; intensifying financial sector reform, including improving the functioning of OschadBank, the state savings bank;
- developing domestic securities markets and further improving the regulatory and supervisory framework for non-banking financial institutions;
- adopting a new law on joint-stock companies and improving the definition of the responsibilities of directors, managers and shareholders' meetings, strengthening information disclosure requirements and increasing the protection of minority shareholder rights.

Global practice in instituting free trade in financial services

To effectively institute changes in the process of Ukraine's integration into the EU and to avoid repeating the mistakes of its predecessors, it makes sense to study the experience of the EU's integration with other countries around the world. The experience of integration with Poland, Jordan and Chile is very interesting, as it demonstrates the EU's integration with economies that are very different in terms of their structure and levels of development. The agreements between the EU and these countries were analyzed in the context of studying the regulation of the financial services markets, free movement of capital and some systemic measures that, among other things, have a significant, direct impact on the markets of financial services.

The EU and Poland⁵⁰

The Free Trade Agreement between Poland and the EU that was in effect before Poland's accession to the European Union regulated key issues in relations regarding the provision of financial services and free movement of capital.

Art. 83 of the agreement regarding the regulation of the banking, insurance and other financial services markets provides for the following measures:

- the adopting of a common set of rules and standards, inter alia, for accounting and for supervisory and regulatory systems in the banking, insurance and other financial sectors;
- the establishing of transparent methods for facilitating the process of reform, in particular by contributing to the preparation of glossaries and the translation of the European and Polish legislation, by holding discussions and information meetings and also by providing training.

Art. 85 of the agreement provides for a number of steps aimed at joint measures between Poland and the EU against money laundering in financial institutions. Cooperation in this area included administrative and technical assistance in establishing suitable standards against money laundering, equivalent to those adopted by the Financial Action Task Force (FATF).

The movement of capital between Poland and the EU was liberalized on the basis of implementing the following principles and measures:

⁵⁰ The Free Trade Agreement between the EU and Poland lost effect after Poland's accession to the EU, but it is of tremendous historical importance.

- the regime of a freely convertible currency for the zloty;
- free movement of capital that services the movement of goods, services and individuals between Poland and the EU;
- free movement of capital in the form of direct investment, a guarantee for the possibility of the unimpeded withdrawal of fixed capital and profits along with investment and protection of investment;
- the ban on instituting any new restrictions on the free movement of capital and currency exchange;
- the possibility of applying restrictions on the movement of short-term and medium-term borrowed capital in the instance of a threat of the destabilization of the financial markets until the moment when the Polish currency gains the status of a freely convertible currency;
- consultations between the parties to facilitate the movement of capital further.

The EU and Jordan⁵¹

The principles of the agreement between the EU and Jordan related to the regulation of the financial services markets and the free movement of capital are largely identical to those constituting the foundation of the EU's agreement with Poland. However, there is a series of nuances in the specific terms and conditions laid out in the agreement. Cooperation between the EU and Jordan in the area of financial services aims at unifying standards and rules for:

- reinforcing and restructuring the financial sector of Jordan;
- improving the country's accounting, supervisory and regulatory systems in the banking, insurance and other sectors of Jordan.

Provisions regulating the rules for the movement of capital between Jordan and the EU provide for:

- the free movement of payments related to the movement of goods, services and individuals;
- elimination of any restrictions on the movement of capital related to direct investment and protection of investment; and
- the possibility of establishing restrictions on the movement of short-term and medium-term borrowed capital in the instance of:
 - the emergence of serious difficulties with implementing an exchange rate and monetary policies;
 - the risks of the emergence of serious imbalances in the current account of the balance of payments.

⁵¹ The Euro-Mediterranean Agreement Establishing an Association between European Communities and their Member States and the Hashemite Kingdom of Jordan.

The agreement between Jordan and the EU sets forth a number of steps that provide incentives for investment:

- harmonizing and simplifying administrative procedures;
- protecting investment and preventing double taxation;
- ensuring mutual access to the capital market to finance investment in industry; and
- setting up joint ventures.

The EU and Chile⁵²

The agreement concluded between the EU and Chile is a systemic document that describes the procedures and technology for cooperation between the parties in the context of mutual provision of financial services in the most detailed manner. The agreement clearly regulates relations between the two parties in the following areas:

- the scope of provisions on free trade in financial services. Specifically, the agreement identifies the procedure for the provision of services by the financial institutions of each party on the territory of the other party and the procedure for the provision of services to individuals by each party on the territory of the other party;
- mutual access to markets. The agreement provides for the freedom from any restrictions related to the number of financial institutions of each party on the market of the other party, the size of their assets, volumes and number of financial transactions affected, etc.;
- equal conditions for access to financial services for entities of each party;
- the institution of new financial services;
- the exchange and processing of data related to the financial services sector;
- the effective and transparent regulation of the financial services sector;
- the procedure for accessing confidential information;
- the procedure for instituting restrictions on free trade in financial services and the movement of capital in the instance of a threat to the stability of both parties' financial systems;
- the creation and rules of a procedure through the Special Committee on Financial Services that supervises the observance of the terms and conditions of the agreement by the parties; and
- the settlement of disputes between the parties.

⁵² The Agreement Establishing an Association between the European Community and its Member States and the Republic of Chile.

Changes needed for an FTA+

Changes in legislation⁵³

A mandatory requirement for the institution of deep free trade in financial services between Ukraine and the EU is the gradual adjustment of Ukrainian legislation to the requirements of the *acquis* that covers the following areas: the banking sector, the insurance services market and the stock market. At the same time, given the fact that Ukraine does not have prospects for EU membership, the country can choose the optimal level of harmonizing national legislation with EU legislation, not resorting to steps to approximate the legislation where it is expensive and economically inexpedient.

The banking sector

The overall level of compliance between Ukrainian legislation on the banking sector and the requirements of the EU *acquis* is rather high. Parts of the legislation that regulate banking activity and, specifically, the law on banks and banking, largely comply with the requirements of the Core Principles of Effective Banking Supervision, adopted by the Basel Committee on Banking Supervision. Ukrainian legislation outstripped a number of Central and Eastern European countries, specifically the Czech Republic, Russia, Latvia and Slovenia in terms of proximity to the legislation.

The main areas for the further adjustment of Ukraine's banking legislation to EU requirements are the initiation and implementation of banking activity, schemes for guaranteeing deposits, the regulation of payments and banking supervision. The most principal discrepancies in the banking legislation of Ukraine and the EU that must be eliminated are the issues of opening bank branches and guaranteeing deposits.

The insurance market

The main pieces of legislation that regulates the provision of services on the country's insurance market are the 7 March 1996 law on insurance and the 12 July 2001 law on financial services and the state regulation of the financial services markets. These laws create an appropriate legal basis that meets EU requirements on the whole.

Harmonization of the Ukrainian and European legislation related to the insurance services market must be carried out on no uncertain terms. Intermediate activities on the insurance market and additional supervision of financial

⁵³ Here, ICPS analysts used material from *The Review of the Progress Achieved in Approximating Ukrainian Legislation to the Acquis Communautaire* prepared by the State Department for the Approximation of Legislation.

conglomerations on a consolidated basis is a must, as are life insurance, other types of insurance, the insurance of the civil liability of vehicle owners and alternative pension security.

The most important issues that must be regulated by Ukrainian legislation are establishing the obligation of insurance companies to inform the State Commission for the Regulation of the Financial Services Markets about majority shareholders or their family members who are directly or indirectly related to the company and supplementing Ukrainian legislation with provisions on additional types of life insurance.

The stock market

The main principles of state regulation on the Ukrainian stock market identified by the law on securities and the stock exchange and the law on the state regulation of the securities market in Ukraine comply with the principles of the EU *acquis*. At the same time, the dynamic development of EU legislation in this area has been a reason behind why Ukraine still hasn't included the last generation of changes in EU legislation to its laws.

The main areas for adjusting the Ukrainian legislation regulating activity on the stock market are clearing and settlement activity and the deposit of securities, regulated markets and the protection of investors, requirements on transparent information about companies whose securities are quoted on the stock market and the prospectuses on issues of securities that are listed and quoted on the stock market.

The most important issues that must be reflected in Ukrainian legislation are the obligation of securities traders to enter investment guarantee funds, the provision of permits by the competent authority to provide investment services or to carry out investment activity only after this authority has obtained the information about shareholders or their family members—whether direct or indirect, legal entities or private individuals—who own a significant portion of a securities trader.

Mutual access to markets

According to the provisions of Art. XVI of the General Agreement on Trade in Services (GATS), the key restrictions whose presence/absence determines the degree of freedom of mutual access for the parties to services markets are the limitations on:

- the number of service suppliers;
- the total value of service transactions and assets;
- the total number of service operations;

- the total number of employees;
- specific types of organizations providing services; and
- the participation of foreign capital.

According to these criteria, Ukraine already has a rather open financial services market. Ukraine's accession to the WTO and the institution of deep free trade with the EU provide for the further significant liberalization of conditions for mutual access of the parties involved to the financial services markets and, thus, gradual simplification of the conditions on Ukrainian financial institutions' entry into EU markets.

As part of deep free trade, one of the most critical issues of Ukraine's integration with the EU is the mutual opening of markets for branches of financial institutions. An important feature of foreign bank branches, insurance companies and investment funds is their direct subordination to a foreign legal entity and accountability to the supervisory authority of the country where the legal entity is registered. Branches of financial institutions are not accountable to supervisory authorities of the country on whose territory they are located.

The attitude of Ukrainian financial institutions to the possibility that branches of western financial institutions will enter the domestic market is negative and is the result of stereotypical fears of being unable to compete with powerful western capital, technologies and standards. At the same time, in terms of competition, branches of foreign financial institutions do not differ from the subsidiaries of foreign banks or the insurance companies that are already actively expanding into the Ukrainian market.

Such groundless fears are refuted by the example of how financial services markets developed within the EU itself, where officials at the European Central Bank admit that one of the problems with integrating their own financial services markets is the fact that businesses prefer setting up banking holdings and subsidiary financial institutions to setting up branches. The explanation of the behavior of European financial structures is that activities of subsidiary banking institutions in the regulatory field of the country where the banks are expanding is frequently more profitable than the operation of branches that must adhere to stricter regulatory requirements that exist in the country where the parent financial institution is located.

The "anti-western lobby" in the financial sector should be seriously weakened as a result of the acquisition of such large domestic banks as Aval, UkrSibBank and UkrSotsBank by western banks in H2'05 – H1'06. Previous owners of these banks and the owners of a number of other large banking institutions that showed interest in the possibility of selling their financial institutions at beneficial conditions achieved by Aval, UkrSibBank and UkrSotsBank lost interest in arguing against foreign presence.

The real value of the advantages that the Ukrainian economy will get from the access of foreign branches to the domestic financial services market is not about stronger competition for local businesses, but about:

- a decline in the levers of influence of the Ukrainian regulatory authorities on the financial services market; and
- payment of taxes by branches of foreign financial institutions in the countries where their parent structures are located.

Free movement of capital

Eliminating restrictions on the movement of capital and ensuring free capital circulation between Ukraine and the EU is a fundamental principle that is absolutely necessary to make implementation of deep free trade in financial services possible.

The rejection of the model of fixed exchange rates and the support for a convertible hryvnia are mandatory pre-conditions for the free circulation of capital, as a macro-economic model built on the basis of fixed exchange rates cannot be effectively combined with the free movement of capital.

The pegging of the national currency to global reserve currencies and the support of a stable exchange rate for national currency are possible on the condition that the volumes of capital imported to the country and exported from the country are the same. If financial flows are not balanced, there will be depreciating or appreciating pressure on the national currency that will be absorbed through the sale/replenishment of the foreign currency reserves of the National Bank of Ukraine.

Lengthy and significant imbalances of financial flows complicate the process of supporting a fixed currency exchange rate with reserves because of growing speculative pressure. Together, these factors will certainly result in the need to resort to measures that restrict the free movement of capital.

The restrictions on inflows of short-term foreign capital in August 2005 are an example of what happens when the free circulation of capital is complicated as a result of the need to support a fixed exchange rate for the national currency.

In August 2005, the National Bank introduced a resolution⁵⁴ that contained stricter reserve requirements for short-term foreign capital. This resolution

⁵⁴ The 12 August 2005 NBU Board Resolution №291 approved the regulation on the procedure for forming mandatory reserves for currency operations related to the attraction of foreign currency loans by residents from non-residents. The size of reserves was established at 20% of the total amount of the operation. The regulation was instituted for a period of six months from the time it came into effect.

made it economically inexpedient to import short-term foreign capital to Ukraine, creating a significant speculative appreciating pressure on the hryvnia against the US dollar.

An opposite example is the existence of restrictions on exports of capital that prevent depreciation of the national currency against world reserve currencies. Instituting restrictions on the free movement of capital when there is a model of fixed exchange rates in place is justified as it eliminates significant risks that can result in macro-economic shocks. Therefore, the free movement of capital must be supported through the rejection of the model of fixed exchange rates.

At the same time, the experience of such countries as Poland, Chile and Jordan in integrating with the EU is evidence that, even if the regime of freely convertible currencies functions, it makes sense to include provisions on possible temporary restrictions on some types of short-term and medium-term capital in free trade agreements in the instance of serious threats to the financial stability of the country.

The FTA+ impact on financial services

The impact on the economy as a whole

The expedience of instituting free trade in financial services between Ukraine and the EU is determined primarily by the impact of consequences of such an FTA+ for the country. The consequences of setting up an FTA+ are divided into three main groups:

- economic;
- social;
- environmental.

In terms of financial services, an FTA+ will not have a direct impact on the quality of the **environment**. However, it can have an indirect impact by influencing the development of economic sectors that will be a priority for investing resources that will come to Ukraine after the creation of an FTA+.

The **social consequences** of setting up an FTA+ will also depend on what economic results are achieved, as the volume of resources channeled into resolving social issues will depend directly on the national income created in the economy.

Economic consequences of instituting an FTA+ can be described through their impact on such indicators:⁵⁵

- the GDP;
- the Consumer Price Index;
- the exchange rate;
- savings and investment;
- the current account of the balance of payments;
- public finances; and
- the unemployment rate.

Foreign experience shows that evaluation of the impact of an FTA+ in the area of financial services on the main indicators of the country's macro-economic development is mainly a qualitative evaluation. At the same time, carrying out a quantitative analysis is rather problematic. An analysis of the impact

⁵⁵ For economic impact assessment of the Free Trade Area between the EU and Mediterranean countries, such indicator groups were used: real income (includes GDP, Consumer Price Index, exchange rate), fixed assets formation (includes savings and investments rates, trade and current account balances), and unemployment.

of setting up an FTA+ between Ukraine and the EU in the area of financial services is presented below.

Analysis according to economic components

Indicator	Impact ⁵⁶	Description of impact
GDP	↑	Growing investment, shrinking loan rates and incentives for consumption will contribute to the long-term acceleration of GDP growth An FTA+ will contribute to growing GDP share of value-added that is created in the financial services sector. For example, in 2005–2006, the financial sector ensured the most significant share of the GDP growth in the EU
The Consumer Price Index	↑	A more open economy will make it possible to absorb the pressure of growing prices. The integration of the EU and Ukrainian markets will contribute to the approximation of price fluctuations on the domestic market on the level of the EU, where the CPI growth is traditionally low and stands at 2–2.5%
The exchange rate	↑	The institution of an FTA+ will help Ukraine transit to a freely convertible currency. Large foreign investment will positively influence the establishment of the hryvnia as a hard currency in the environment when the system of fixed exchange rates is rejected
Savings and investment	↑	An FTA+ will improve access for financial institutions and businesses as a whole to powerful investment resources of the EU and will also have a positive impact on the FDI growth and the attraction of loan capital At the same time, shrinking interest rates and growing imports will increase household consumption, which will have a contradictory impact on the level of savings and internal investment The overall impact of an FTA+ on savings and investment will be positive
The balance of payments	↑↓	An FTA+ in the area of financial services will result in a growth in imports of consumer and investment goods. At the same time, growing imports and the shrinking positive (growing negative) balance of payments will be fully financed by investment
Public finance	↑↓	Enlivened economic activity, growing investment and the GDP will contribute to growth in the national income and, thus, to growing Budget revenues. At the same time, a decline in Budget revenues would occur as a result of the: <ul style="list-style-type: none"> – payment of taxes by branches of foreign financial institutions into the budgets of the countries where their headquarters are located – cancellation of the fee paid into the Pension Fund for currency exchange operations
Unemployment	↑↓	The growing number of jobs resulting from the overall enlivenment of economic activity will be, at the same time, compensated by the reduction of personnel, which will happen as a result of growing productivity.

Thus, despite the existence of certain negative consequences—that can be minimized—the impact of instituting an FTA+ in the area of financial services on the economy as a whole will be positive.

⁵⁶ “↑” – positive impact; “↓” – negative impact; “↑↓” – contradictory impact; “=” – insignificant or no impact.

The impact on common issues regarding financial services markets

Supervision and oversight

The institution of an FTA+ between Ukraine and the EU will have a positive impact on the quality of supervision and oversight of activities carried out by financial institutions. On the whole, the Ukrainian financial services markets have an effective supervision system that meets the basic principles of the Basel Committee on Banking Supervision. At the same time, a number of bankruptcies and problematic situations in the segment of small and medium financial institutions is evidence of the need to improve procedures for internal management and also oversight and supervision procedures.

The institution of an FTA+ with the EU will result in the growing effectiveness of implementing supervisory functions in the following areas:

- **IMPROVEMENT OF INTERNAL PROCEDURES FOR EVALUATING CAPITAL ADEQUACY OF FINANCIAL INSTITUTIONS**, according to the risks and development strategies specific for them. This is based on analyzing:
 - internal management procedures;
 - capital stability;
 - the system for evaluating risks (market, lending and operational risks);
 - the internal reporting system; and
 - the system for internal oversight and audit.
- **INTERACTION OF SUPERVISORY BODIES AND FINANCIAL INSTITUTIONS** in the context of monitoring internal procedures for evaluating capital adequacy and risks of financial institutions by supervisory authorities.
- **INCENTIVES FOR FINANCIAL INSTITUTIONS TO INCREASE CAPITAL AND RESERVES** to cover risks in the amounts that exceed the minimum requirements of the regulatory authorities.
- **DEVELOPMENT OF EFFECTIVE PROCEDURES BY SUPERVISORY AUTHORITIES TO TIMELY REVEAL THE RISKS** of shrinking capital in financial institutions below the level established by the minimum requirements and effective procedures to influence them to renew the appropriate level of capital to cover risks.

Improvement of the supervisory system in the process of instituting deep free trade between Ukraine and the EU will significantly reduce the possibilities for fraud among owners of financial institutions and will help make it impossible for them to withdraw assets and to organize the artificial bankruptcy of financial institutions.

Better monitoring and anti-money laundering procedures

Harmonization of Ukrainian legislation with the legislation of the EU and deeper cooperation with European structures to combat money laundering in the process of instituting an FTA + with the EU will have a positive impact on the improvement of procedures for financial monitoring and the combat against money laundering.

In recent years, Ukraine has taken serious steps in creating and improving the system of financial monitoring. The central element of the system for combating money laundering is the State Committee for Financial Monitoring.⁵⁷ The committee collects and analyzes information about the questionable operations of clients that, according to the requirements of legislation on combating money laundering, comes through communication channels from banks, stock exchanges, credit unions, insurance companies and professional participants on the securities market.⁵⁸ If the suspicions regarding the illegality of operations are confirmed, this information is transferred to the Ministry of Internal Affairs, the SBU, the Ukrainian security service, the Prosecutor General Office, the State Tax Administration, etc.

As a result of systemic works to combat money laundering, Ukraine managed to expose and eliminate a number of illegal schemes used in operations involving securities, on the insurance market and in the banking system. Ukraine's efforts were recognized by the international community, confirmed by the removal of the country from the FATF black list.

Despite certain achievements in recent years, the shadow sector continues to account for a very large portion of the country's economy. According to some estimates, the volumes of the shadow sector are absolutely comparable with the volumes of the legal economy. Further enlivenment of Ukraine's cooperation with the FATF, the Council of Europe/the European Commission and other international organizations for combating money laundering and the financing of terrorism, which is a necessary pre-condition for setting up effective deep free trade between Ukraine and the EU, will have a serious positive impact on the country's economy as a whole.

The process of improving procedures in financial monitoring and combating money laundering could face the severe resistance of specific business groups

⁵⁷ The State Committee for Financial Monitoring was set up on 10 January 2002. The committee carries out lively activity to combat money laundering and the financing of terrorism (effective 12 June 2003, after the law on preventing and counteracting the legalization of illegal incomes (money laundering) came into force. On 1 January 2005, the State Committee for Financial Monitoring gained the status of a central government body.

⁵⁸ Throughout 2005, the State Committee for Financial Monitoring received more than 800,000 reports on questionable financial operations from primary subjects of financial monitoring. About 97.7% of such reports came from the banking system and 2.3% of them came from non-banking financial institutions.

that broadly use semi-legal schemes for operation in order to minimize tax payments and to withdraw capital abroad.

Higher quality of services

An FTA+ with the EU will create pre-conditions for a significant improvement in the quality of financial services through heavy investment in the development of the country's infrastructure, information systems and the introduction of modern, integrated software compatible with that of Europe. The current range of services offered by Ukrainian financial institutions, as well as their accessibility and affordability for clients, is not satisfactory. An example of poor quality services is the high cost and low affordability and accessibility of significant long-term loans for average Ukrainians and businesses that are not affiliated with banking institutions.

The meeting of EU standards in the quality of service provision is a mandatory consequence of setting up deep free trade in the area of financial services, which will have a positive impact on the business activity of Ukrainian companies and individuals and their comfort in their contact with financial institutions. The removal of a number of institutions with a low levels of competitiveness from the market is the price of instituting deep free trade.

The impact on specific sectors

The banking sector

An FTA+ with the EU will have mostly a positive impact on the development of the banking system. The main advantages of deep free trade in financial services with EU Member States in the banking sector are:

- improved access to the powerful and cheap financial resources of the EU, which will contribute to improving the growth dynamic of capital and assets of financial institutions and reduce the cost of these processes;
- lower systemic risks;
- higher quality of corporate governance;
- improved lending ratings of banking institutions as a result of lower systemic risks and higher quality in corporate governance;
- reduced dependence of banking institutions on financial and industrial groups; and
- facilitated conditions for the entry of Ukrainian banks onto the EU market.

The negative consequences of deep free trade for the banking system are related mainly to specific interest groups. An overall risk of an FTA+ for all participants in the banking market is more severe competition and the threat of leaving the market for those who cannot stand this competition.

The stock market

Legislative changes needed to organize deep free trade between Ukraine and the EU will have a significant positive impact on the development of the Ukrainian stock market through:

- engaging large assets in the circulation on the organized stock market that currently cannot be the object of trade as they are owned by market participants organized in the form of closed joint-stock companies;
- making the structure of business property transparent; and
- protecting the rights of minority shareholders.

Losses from these steps will be inflicted upon owners of specific business groups as a result of the need to sustain expenditures on changing the organizational and legal form of their companies and their inability to adjust to the operation in a more transparent manner.

The insurance market

Deep free trade in financial services will facilitate the access of Ukrainian insurance companies to EU standards and technologies. The institution of these standards and technologies, along with powerful western capital, will contribute to the more dynamic development of classic "pure" types of insurance on the Ukrainian market. An FTA+ will have a positive impact on the formation and the development of the non-government pension security sector. The actual lack of financial services in this sector on the Ukrainian market makes it possible to form this sector from scratch on the basis of EU principles and standards. The threat of bankruptcy for a number of insurance companies in a more severe competitive environment is a negative consequence of deep free trade.

The impact on stakeholders

An FTA+ in financial services affects interests of many business entities. To reveal interests of stakeholders and to find the optimal balance of such interests is an indispensable condition for uniting all stakeholders in the process of moving towards free trade in financial services with the EU and for obtaining those important advantages and benefits that it will provide on the whole. Below, we present the most important consequences of deep free trade for households, businesses, financial institutions, the state and regulatory authorities and the country's economy in general.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Households	<ul style="list-style-type: none"> Improved conditions for access to loans Expanded range of financial services Higher quality of services Stronger competition among financial institutions for clients 	<ul style="list-style-type: none"> Shrinking number of employees Stricter working conditions
Businesses, financial and industrial groups	<ul style="list-style-type: none"> Improved conditions for access to loans Transparent mechanisms for attracting investment resources Investor rights protection An expanded range of financial services Higher quality of services Stronger competition among financial institutions for clients 	<ul style="list-style-type: none"> Disclosure of the structure of property Changes in the organizational and legal forms of activity (for closed joint-stock companies) Higher risks of losing control over business
Financial institutions	<ul style="list-style-type: none"> Higher quality of corporate governance Improved access to powerful financial resources Lower cost of resources Lower systemic risks Investor rights protection Lower dependence on financial and industrial groups and related entities Improved technologies and standards in service provision Simplified procedures for entering the EU market 	<ul style="list-style-type: none"> Stronger competition on the market Disclosure of the structure of property (for owners of financial institutions) Changes in the organizational and legal forms of activity (for owners of closed joint-stock companies and limited liability companies) Higher risks of losing control over business Removal of those who cannot stand competition from the market
State and regulatory bodies	<ul style="list-style-type: none"> Improved supervision and oversight procedures Enhanced overall condition of the regulated systems Higher transparency of the financial services markets 	<ul style="list-style-type: none"> Expenditures on preparing for an FTA+ Expenditures on harmonizing legislation with EU norms Weak control of branches of foreign financial institutions Cancellation of a fee to the Pension Fund for non-cash currency exchange Payment of taxes by branches of foreign financial institutions into the Budgets of the countries where their headquarters are located
The economy as a whole	<ul style="list-style-type: none"> Improved access to powerful and cheap resources Growing foreign direct investment Better Ukrainian legislation Institutional development and the development of the infrastructure The development of the stock market The development of non-government pension security The improvement of the insurance market The improvement in combating money laundering 	<ul style="list-style-type: none"> Less possibilities for the state to control the development of financial institutions Growing dependency on external factors An increase in bankruptcies among those who will not stand against more severe competition



Transport

Establishing a competitive economy with globalization in full swing requires Ukraine to integrate effectively into the world community. An important step in this direction is the completion of World Trade Organization (WTO) accession. Although transport services are among Ukraine's major export services, important segments of this sector have been excluded from the structure of the World Trade Organization and the General Agreement on Trade in Services. Three main factors explain this exclusion:

- air transport is regulated by a separate multilateral agreement, the Chicago Convention;*
- cross-border automotive and railway transport occurs mainly between adjacent neighbors, leaving little reason for a multilateral regime;*
- the main policy issues around sea transport affect ports and are generally considered a prerogative of internal policy.*

Thus, investment decisions and decisions to reform policy to establish more efficient regional transport streams must be made either through changes to domestic policy or bilateral processes between Ukraine and its trading partners.

This section looks at possible forms of transport cooperation between Ukraine and the EU in the context of a Free Trade Agreement and assesses how the Agreement's provisions affect various stakeholders.

A brief overview of transport

Ukraine's transport sector is an important part of the domestic economy. In 2005, transport services accounted for one tenth of GDP and the sector employed nearly 730,000 workers. Ukraine's favorable geographic location and the availability of transport links are fostering the growth of transit traffic. Ukraine's closeness to European markets facilitates the export of domestic goods and the inflow of investment in new production.

Ukraine has a developed network of transport links consisting of 43,100 km of trunk pipelines, 22,100 km of railway lines, 164,200 km of hard-surface roadways, and 12,300 km of operational river routes. Over 58,000 commercial entities, 32 airports, 20 state-owned seaports and 10 river ports, 6 railway companies, 97 airlines, and about 150 shipping companies work on the market. Various international transport corridors cross Ukraine's territory, including four of the nine pan-European corridors. Ukraine's well-developed gas transport system and oil pipelines are a strategic advantage, making the country one of the leading places in the world for fuel transit.

Development trends

Trends in the transportation in Ukraine reflect the economic situation. After the economic collapse of the early 1990s, volumes of both freight and passenger carriage collapsed. The economic boom since 2000, which was accompanied by rising personal incomes and growing commercial activity, ushered in a revival in the transport sector.

Table 10. Some statistics on Ukraine's transport sector, 2005

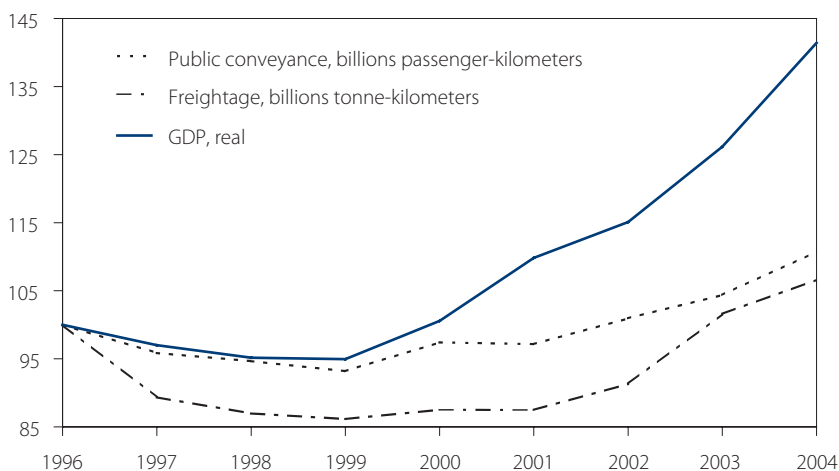
Mode of transport	Freight traffic		Passenger traffic		Operating revenues, UAH bn
	mn t	% of total volume	million passengers	% of total volume	
Rail transport	448.9	76.8	516.4	11.8	20.4
Road transport	127.4	21.8	3,800	88.0	...
Transport by water	7.8	1.3	4.7	0.1	5.9
Air transport	0.1	0.1	3.8	0.1	...

Source: Derzhkomstat; calculations by ICPS

According to Ministry of Transport and Communications data, for Ukraine to ensure sustainable economic development at 6–8% for the period up to 2020 will require that this growth ensure a 1.5–2-fold increase in freight traffic, 1.3–1.5-fold increase in passenger carriage, and a "European" quality of service. A significant part of demand will be for international traffic and transit.

Chart 9. Growth in transport: Ukraine

index, 1996=100



Source: Derzhkomstat; calculations by ICPS

Barriers to development in the sector

Ukraine's transport potential is high but greatly underused. According to World Bank estimates, Ukraine was losing US \$400mn a year as a result of the slow modernization of transport corridors. These losses include the failure to generate additional jobs and uncollected profits from exporting goods and services. The major development problems in the sector are:

- highly inefficient infrastructure due to the level of depreciation of basic assets—nearly 52%;
- monopolization in certain competitive market segments;
- highly uncompetitive transport complex enterprises, first of all because of the lack of correspondence to international standards. For instance, in Ukraine, vehicles do not meet environmental standards and sometimes do not correspond to what the economy actually needs.⁵⁹

The inefficiency of Ukraine's transport sector is a major non-tariff barrier to integration into the EU. Even when the physical infrastructure is adequate, efficiency remains low. Flawed regulations are among the reasons behind such a situation. For instance, in port services, competition is restricted; in aviation, the private sector is barely involved; and in crossing borders, procedures are too long and complicated.

⁵⁹ For example, the loading capacity of most soviet-made trucks is huge, 4–8 t, which leads to low loading levels—usually 10–30%. By comparison, the overwhelming majority (70%) of truck fleets worldwide have a capacity of only 1.5 t.

Priorities in cooperation with the EU⁶⁰

One of the principal goals of in developing Ukraine's transport sector is its ability to ensure the efficient carriage of goods and people. This is critical for integration between Ukraine and the EU. Apart from an adequate infrastructure, Ukraine needs an appropriate level of transport services, that is, speed and safety, and competitive prices for the services provided in order to reach this objective.

From the point of view of deep integration, **three major priorities** for cooperation should be:

- negotiating an "open sky" policy with Ukraine's eventual inclusion in the EU common civil aviation zone;
- developing a network of international transport corridors (TCs);
- eliminating barriers to crossing the borders with a special emphasis on reforming customs.

At the moment, trade in transport services is mostly in Mode 1 (cross-border trade) and Mode 2 (consumption abroad).⁶¹ Facilitation of trade and transport could expand the potential for growth in both of these modes.

However, the main dormant opportunity to deepen integration in the transport sector is trade in Mode 3 (commercial presence). Even if access to markets is not officially denied, natural monopolies over most transport infrastructure and state ownership, which can be encountered anywhere, mean that attracting foreign investment will require privatizing infrastructure such as port terminals and movers, as well as granting concessions in airport terminals, container port terminals, highways, and so on.

The main instruments for cooperation

The main priorities and measures in transport and communications anticipated by FTAs between the EU and Poland, Jordan, and Chile are provided below.

⁶⁰ Materials from "The Prospect of Deep Free Trade between the European Union and Ukraine" report are used here and further.

⁶¹ According to the General Agreement on Trade in Services there are four modes for supplying services: 1) cross-border supply or cross-border trade; 2) consumption abroad; 3) commercial presence; and 4) the presence of natural persons.

EU–Poland⁶²

Developing cooperation in this area had to allow Poland to:

- restructure and modernize its transport sector;
- facilitate the movement of people and goods, improve access to the transport market by eliminating administrative, technical, and other hurdles;
- make standards consistent with the EU standards.

Measures:

- economic, legislative, and technical educational programs;
- technical assistance and knowledge transfer (conferences and workshops).

Priorities:

- road transport, especially gradual easing of transit terms;
- railroad and airport management, especially interaction between corresponding national ministries and agencies;
- modernizing roads, internal waterways, and port and airport infrastructure that are part of networks of common interest, trans-European corridors;
- construction planning, especially urban planning;
- upgrading equipment according to EU standards, especially in auto and rail transport, multi-modal carriage, trans-shipment;
- establishing a consistent transport policy that is closer to EU policy.

EU–Jordan⁶³

Goals of cooperation:

- restructuring and modernizing the infrastructure of roads, ports and airports of common interest, trans-European corridors;
- establishing and applying standards valid in the EU;
- upgrading equipment to the level of the EU standards applied to road and rail transport, container movement and trans-shipment;
- mutual easing of transit terms;
- improving airport, railway, and air control management, including cooperation among major national ministries and agencies.

EU–Chile⁶⁴

Goals of cooperation:

- restructuring and modernizing Chile's transport system;
- improving the movement of people and goods, access to urban, air, sea, rail, and road transport markets by eliminating administrative approaches to transport management and promoting functional standards.

⁶² This Free Trade Agreement between lost effect after Poland joined the EU.

⁶³ The Euro-Mediterranean Agreement establishing an Association between the European Communities and their Member States, of the one part, and the Hashemite Kingdom of Jordan, of the other part.

⁶⁴ The Agreement establishing an Association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part.

Measures:

- exchanging information related to the parties' transport policy, especially on urban and international transport, and the compatibility of multi-modal transport networks and common problems;
- training programs in economic, legislative and technological activities for market participants and high-ranking government officials;
- common projects in the transfer of EU technologies related to the global satellite navigation system (Galileo) and urban hubs for public transit.

Cooperation between Ukraine and the EU in the transport sector could focus on two main issues:

1. **PHYSICAL INFRASTRUCTURE FOR THE FUNCTIONING OF THE FREE TRADE AREA.** Carrying out priority infrastructure projects, above all along trans-European transport corridors through:

- cooperation with EU partners in funding and implementation;
- adopting legislation to make partnership between public-private partnerships possible in this sector;
- establishing an efficient mechanism to coordinate state policy.

2. **GRADUAL FORMATION OF A UNIFIED MARKET FOR TRANSPORT SERVICES** in separate segments of the sector through the harmonization of legislation and the regulatory environment. This requires implementing a number of horizontal measures:

- simplifying procedures for crossing borders and registering cargo;
- introducing transport documents based on EU standards;⁶⁵
- introducing a single approach to measures for ensuring physical safety in accordance with international agreements and standards;
- entering relevant supra-national European structures.

The steps involved in adapting domestic legislation to EU norms and standards are also defined by existing bilateral agreements⁶⁶ (see **APPENDIX 4** on the progress of adaptation).

⁶⁵ Instituting transport documents based on EU standards anticipates, among other factors, simplifying the language of the paperwork and mutual recognition of all trade and transport documents in the domestic language and English, and harmonizing them in the future.

⁶⁶ See the Agreement on Partnership and Cooperation between Ukraine and the EU; the Ukraine – EU Action Plan; the Cabinet Resolution "On the Statute on Measures for Implementing the Ukraine – EU Action Plan in 2005"; the Cabinet of Ministers Decree "On the Statute on Measures for Implementing the Ukraine – EU Action Plan in 2006"; the Ukraine – EU Agreement on Some Aspects of Air Communication (a "horizontal agreement"); the Positional Document on the Ukraine – EU Action Plan Implementation.

The FTA+ impact on transport

Despite the clear advantages of integrating transport sectors operating in both Ukraine and the EU as part of the process of establishing a deep free trade area (FTA+), the potential impact of this process on Ukrainian business interests, individual Ukrainians and the state as a whole needs to be fully examined. Identifying the interests of all the stakeholders and taking them into account at the decision-making stage is an indispensable condition for establishing the deep free trade area between Ukraine and the EU in the most effective way.

Based on the issues selected, stakeholders in this sector include:

- domestic carriers and other businesses, such as makers of transport equipment and travel agencies;
- regulatory bodies, central and local government agencies;
- the general population (users of transport services in Ukraine/abroad).

Obviously, the practical opportunities for integrating differ significantly in various segments of the transport sector, depending on the progress of adapting legislation and the institutional capacity for instituting changes. For example, there are real prospects for Ukraine's aviation sector to be integrated into the European Common Aviation Area by 2010, whereas formation of a single market for services provided by river transport remains a distant issue.

Aviation

Within the framework of the European Neighborhood Policy, the European Commission set out a strategy for the integration of Member States into a European Common Aviation Area by 2010.

After successful negotiations between Ukraine and the EU on "a horizontal aviation agreement" in 2005, which brought some provisions of bilateral agreements in the field of aviation communication between Ukraine and other Member States in line with the EU legislation, the European Commission requested a mandate to hold talks on the formation of a common aviation area between Ukraine and the EU.

Thus, the EU is prepared for relations in the aviation that even go beyond the FTA+ framework, as the discussion is about Ukraine's entering a single European aviation market.⁶⁷ For this purpose, Ukraine has to harmonize its domes-

⁶⁷ See http://europa.eu.int/comm/transport/air/international/index_en.htm). Currently, the European Common Aviation Area will have two major components: a) harmonized aviation standards and regulatory environment; b) a single aviation market uniting 35 countries with a population of over 500 million.

tic legislation with all the EU laws on aviation. This largely means full liberalization of rights connected with air traffic and bringing ground maintenance regulations in line with EU standards, increasing transparency in the regulation of airport dues and flight routing, and establishing international standards and institutional cooperation as far as air traffic control and safety and reliability issues are concerned.

Possible cooperation/measures under an FTA+

Ukraine measures	EU measures
Membership in the European Aviation Safety Agency (EASA) ⁶⁸ and a full membership in such organization as the Joint Aviation Authority (JAA) and the Common Bodies for Regulating Aviation in Europe ⁶⁹	Resolving the issue of certifying products made by the Ukrainian aircraft industry
Opening the domestic market to top international airport operators	Promoting inflows of EU investment in the sector
Privatizing airlines with the participation of top European carriers before the market is fully open	Supporting technical assistance from ICAO and EASA to the State Aviation Administration ⁷⁰
Eliminating barriers to market access for foreign-made aircraft (dropping the VAT on imported aircraft)	
Harmonizing sector legislation with EU standards	

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian airlines	Lower prices for foreign-made aircraft Less arbitrary impact by state officials on business through Ukraine's participation in supranational regulatory bodies	Growing competitiveness and possible squeezing out of the market or being swallowed up by EU rivals
Ukrainian airports	Modernization and expansion of traffic capacity	
Ukrainian aircraft makers	Favored entry into EU markets, such as CE states, where aircrafts engineered by the Antonov Design Bureau are commonly used	Stronger competition due to better opportunities to exploit hi-tech transport

>> *continued*

⁶⁸ In 2004, Ukraine became a full member of the European Organization for Air Navigation Safety (Eurocontrol), which coordinates air traffic control in Europe.

⁶⁹ The Organization includes 39 members and its functions will be soon integrated into the European Aviation Safety Agency (EASA). EASA's authorities have not been finally defined yet. In November 2005, the European Commission called on EU Member States to expand EASA powers to include monitoring the compliance of airlines not based in the EU with EU safety and reliability rules. This institution will probably also be made responsible for airport safety.

⁷⁰ In 2006, a State Aviation Administration was established as part of the Ministry of Transport and Communication. This makes MTC the State Aviation Service's legal successor, whereas the State Aviation Administration is a successor of the State Department of Air Transport. Until a separate aircraft accident investigation agency is established, the State Aviation Administration will hold inquiries into accidents involving civilian aircraft on Ukraine's territory, as well as accidents involving Ukrainian civilian aircraft abroad.

Stakeholder	Pros	Cons
Government/ regulatory bodies	<p>Growing Budget revenues with growing volumes of traffic</p> <p>The formation of comprehensive regulatory and control systems</p> <p>Better conditions for integrating into EU structures and introducing EU safety and environmental standards</p> <p>The possibility of using EU resources to handle internal issues within the framework of the related instruments for assistance</p>	<p>Possible squeezing of uncompetitive state-owned companies</p> <p>Costs for harmonizing the legal framework with EU norms</p> <p>Less self-sufficiency as a result of partial delegation of authority to supra-national bodies, such as in the case of integration into the European Common Aviation Area</p>
The general population, consumers in Ukraine and abroad	<p>Expanded spectrum and quality of services</p> <p>Greater protection of consumer rights in accordance with EU standards</p> <p>Greater transport safety</p>	

Road and rail transport

In the context of an FTA+, the priority for developing land transport, which handles for larger part of cargo and passenger traffic between Ukraine and the EU, consists in ensuring the physical movement of goods and services within the framework of Ukraine – EU trade and economic relations and transit flows. The latter includes taking advantage of the opportunities presented by trans-European transport networks that cross Ukrainian territory.

The use of the Ukraine's transit potential is especially important for EU Member States, as it means access to Russian, Transcaucasian and Central Asian markets. Specifically, for some of the new EU members, like Hungary and the Czech Republic, transit through Ukrainian territory is actually the only possible way to maintain trade ties. In addition, Poland is interested in organizing multi-modal communication between Warsaw and Kyiv, whereas Austria, Slovakia and the Czech Republic are interested in communication between the Ukrainian border and the industrial region of Zlin.

For Ukraine's physical infrastructure to develop and ensure links between Ukraine and the EU, as well as transit traffic, the Central Axis is seen as a priority.⁷¹

These are the priority investment projects:

- developing the Odesa and Illichivsk ports;
- constructing a railway tunnel between the Beskids and Skotarske;
- establishing warehouse centers and related infrastructure in Chop;

⁷¹ Includes a multi-modal links in these directions: 1) Dresden – Katowice – L'viv – Kyiv; 2) Budapest – L'viv; 3) Moscow – Kyiv – Odesa; 4) Minsk – Kyiv; 5) Kyiv – Kharkiv – the Trans-Siberian Railroad/the Caucasus; 6) the Belarus – Kyiv – Odesa internal waterway along the Dnipro.

- modernizing the Kyiv – Zhashkiv and Chervonoznamyanka – Odesa sections of the Kyiv – Odesa highway;
- establishing of warehouse centers and related infrastructure in Usatove in Odesa Oblast, in Dnipropetrovsk and in Kharkiv.

Full use of transport network capacities involves:

- ensuring adequate transport infrastructure (roads, terminals, and so on) on Ukraine’s territory and eliminating bottlenecks at the border by increasing their capacity;
- harmonizing norms and legislation that regulates international and domestic traffic and border control;
- introducing key EU norms and standards.

In addition, cooperation between authorized agencies concerning safety when transporting hazardous cargoes, including fuels (oil, petrol, gas etc.) should be ensured for all modes of transport within the framework of an FTA+.

Possible cooperation/measures under an FTA+

Ukraine’s measures	EU measures
Concentrating resources on key projects along the international transport corridors belonging to the trans-European transport networks (TEN-T)	Offering Ukraine extra financing to help develop its own transport corridors (e.g., through the European Investment Bank loans) ⁷²
Harmonizing the regulatory environment for international and domestic transportation and control over cross-border movement.	
Acceding to the European Rail Traffic Management System	
Eliminating obstacles, such as over-regulated cargo registration and customs procedures, which will make it possible to fully use available opportunities ⁷³	
Adopting the <i>acquis</i> related to liberalizing freight traffic	
Attracting foreign operators to modernize infrastructure and improve its efficiency by introducing the necessary amendments to legislation ⁷⁴	
MTC participating more actively in the work of the oversight agencies of trans-European transport networks	

⁷² The High-Level Group for Enlarging TEN-T over the territory of neighboring countries and regions has defined EU sources of funds (EBRD and EIB), which have to partly solve the issue of financing priority investment projects singled out by the Group.

⁷³ For example, the integration of Ukraine’s transport system into TEN-T will be impossible without bringing a signal system and information systems in line with All-European standards.

⁷⁴ Liberalizing port services and concessions for other key terminals is also on the table. Ukraine has to open the sector to foreign investors and, correspondingly, to Mode 3 trade.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian business	<ul style="list-style-type: none"> More opportunities for commercial cooperation domestically and abroad, expanded tourism Greater investment appeal in the regions Growth of secondary transport markets (filling stations, hotel, and so on) Better opportunities to use hi-tech transport and cut deterioration caused by bad roads Less corruption through simplified procedures in international traffic and greater transparency of operations Fewer costs related to inconsistency of transport documents and standards for cargo registering and transportation 	<ul style="list-style-type: none"> Stronger competition and possible squeezing out of from the market or being swallowed up by EU rivals Increased costs for meeting safety, labor protection, and environmental standards, as well as upholding consumers' rights
Ukrainian makers of transportation vehicles and equipment		<ul style="list-style-type: none"> Stronger competition with more opportunities to use hi-tech transportation vehicles
Government/regulatory bodies	<ul style="list-style-type: none"> Growing Budget revenues with growing volumes of transportation The formation of comprehensive regulatory and control systems Better conditions for integrating into EU structures and introducing EU safety and environmental standards The possibility of using EU resources to handle internal issues within the framework of the related instruments for assistance 	<ul style="list-style-type: none"> Possible squeezing of uncompetitive state-owned companies Costs for harmonizing the legal framework with EU norms
The general population, consumers in Ukraine and abroad	<ul style="list-style-type: none"> Expanded spectrum and quality of services Greater protection of consumer rights in accordance with EU standards Greater mobility for workers New jobs 	<ul style="list-style-type: none"> Possible extra costs related to using modern transport infrastructure (toll roads) Threat of job losses due to competition with EU companies

Other modes of transport

Although sea transport accounts for a minor part of cargo traffic between Ukraine and the EU, it is important for transit trade and the efficiency of the overall multi-modal system. Ukraine has to put together a comprehensive strategy on ports,⁷⁵ especially plans for developing infrastructure, improving junctions with land transport, and establishing the substance of regular and institutional reforms.

The High-Level Group has recognized the Odesa port as a priority for the Sea Trunk Line and an important node in the Central Axis. The European Commis-

⁷⁵ UkrMorPort, a state concern designated to unite 19 state ports, was founded on 30 November 2006.

sion recently offered the Second Packet on Ports, which anticipates establishing a higher level of competition in EU port services. The rules enshrined in it could be an example for similar reforms in Ukraine. And, finally, since Ukraine is one of the countries with the largest number of sailors worldwide, about 50,000, the EU aims at toughening Ukraine's labor laws and their enforcement.

Although Ukraine's internal waterways are 4,400 kilometers long, they play an insignificant role in Ukraine – EU traffic. The country has limited access to the most important EU internal waterway, the Rhein – Main – Danube corridor stretching 3,500 kilometers from Rotterdam in the North Sea to Sulina, Romania, in the Black Sea. Ukraine has signed a Memorandum of Understanding on the Development of the Pan-European Transport Corridor VII (The Danube) and is a member of the Steering Committee.

However, the Danube adjoins Ukraine only along the southern border with Romania. Just a small part of its delta is located on Ukraine's territory. Most traffic bypasses Ukraine, going through Romania. However, the Ministry of Transport and Communication's plans to re-open the silted Prorva channel from the Danube to Ukraine's Black Sea coast will violate the Ukraine's international commitments regarding preservation of the Danube delta. The Delta is an unstable biosphere that was put on UNESCO's World Heritage List in 1991.

Another important trans-border riverway is the Dnipro, which unites Belarus and Ukraine and was defined as part of the Central Axis by the High-Level Group.

Pipelines are a separate transportation mode, important for long-range movement of oil and gas. Some three fourths of Russian gas exports to the EU go through Ukraine's transit pipelines. That is why state policy issues on pipelines deal mostly with the energy sector.

Communications and a Free Trade Agreement

Similar to the transport sector, the communications sector plays a key role in ensuring the free movement of goods and services and establishing a knowledge-based economy. In some sectors (finance, outsourcing services, media), communications have become a principal means for establishing related global markets. For the Ukrainian communications sector to fully carry out its function of “the integrator, the connecting link,” the domestic legislation needs to be adapted to the *acquis*, in addition to modernizing infrastructure.

Today, Ukrainian legislation corresponds highly to the EU Telecommunications Legislation Package of 1998.⁷⁶ Unlike the transport sector, where Ukraine has virtually no international commitments for lack of similar requirements in the WTO accession process, Ukraine has undertaken commitments to provide all forms of telecommunications and to carry out certain international demands regarding sector management principles. Thus, the most crucial issue to be settled within the framework of an FTA+ must be the practical implementation of the corresponding *acquis* by increasing the institutional capacity of the national regulator and introducing EU norms and standards to ensure a generally competitive environment. This means setting up equal opportunities for access to a full range of services on Ukrainian territory and fostering investment inflows.

Generally, the impact of an FTA+ on the telecommunications sector will be limited, although legislative harmonization within the context of the Agreement will make it possible not only to increase the appeal of the sector to EU investors, but also to establish conditions for the country to become more competitive on the overall European telecommunications market.

⁷⁶ See recommendations on bringing domestic communications legislation in line with the 2003 EU directives in the “Back to the drawing board: Restructuring Ukraine’s network industries” analytical brief, <http://indeunis.wiwi.ac.at/index.php?action=content&id=publications>.



The steel industry

The impact of free trade with the European Union on a given industry will depend largely on the degree of openness of markets, after Ukraine accedes to the WTO, as well as on the degree to which a given product meets sector standards that have been adopted in the EU.

This chapter looks at possible forms of cooperation between Ukraine and the EU in the steel industry within the context of an FTA+ through:

- *an analysis of possible forms of cooperation and the kinds of policies that will be needed in order to adapt Ukrainian legislation for the purpose of increasing the competitive edge of Ukraine's steel products;*
- *impact analysis of various provisions in such an agreement for different sector interest groups.*

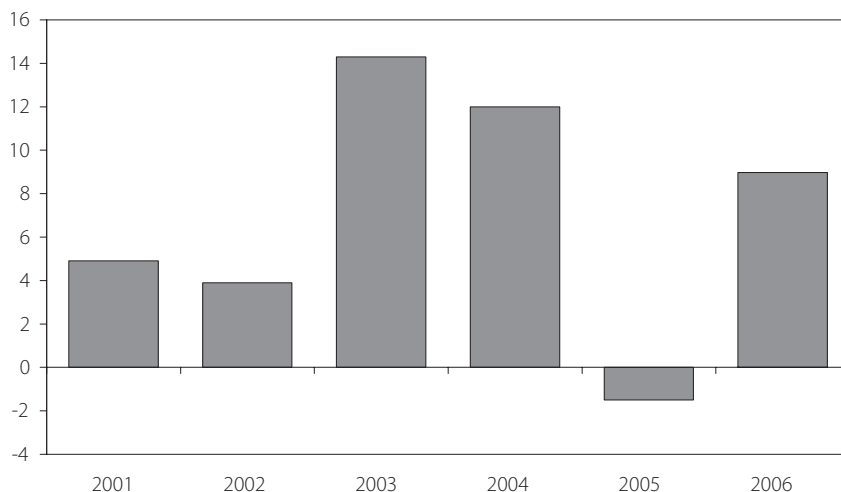
A brief overview of the steel industry

Over the last five years, the steel industry has been the leading sector driving economic growth in Ukraine. In 2005, this sector represented 25% of all industrial production in the country. Of the 38.6mn t of steel produced that year, 28.2mn t were exported, amounting to nearly 7% of global steel trade. The competitiveness of Ukrainian steel is based on enormous deposits of iron ore and coking coal, a good geographic location, and low energy and labor costs.

A downward trend on foreign markets put a brake on the sector's dynamic growth in 2005, however. World prices for steel began to slip and growing competition in Asia in H1'05 led to a noticeable slowdown in steel exports. Meanwhile, prices for natural gas and electricity kept rising throughout 2005 – 2006.

Chart 10. Steel industry output

% annual change



Source: Derzhkomstat

But in 2006, the situation improved once again. Figures for January – November 2006 show that the sector's growth picked up 8.5% because of a favorable global steel situation and the ability of domestic steelmakers to quickly expand capacities to meet rising demand.

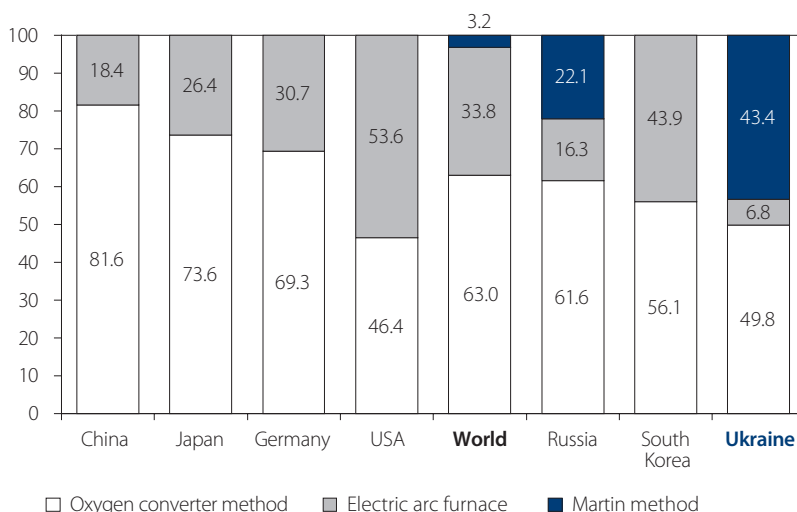
The shifting dynamic of the sector's growth over 2005 – 2006 made it clear how dependent this sector is on external factors, especially world prices and demand for steel products. The domestic market uses only about 20% of the

industry's output. Thus, the main problems facing the steel industry's further development are:

1. **OUTDATED TECHNOLOGY.** Fixed assets in the sector have depreciated by about 60–70%. Coupled with the fact that industry is subject to only soft budget constraints,⁷⁷ a policy of mild modernization allowed companies to maximize their profits. The resulting lack of incentives to modernize was a reflection of the fact that outdated technology dominated the industry's production lines.

Chart 11. Steel processing technology, 2004

share of various technologies, %



Source: International Institute of Iron and Steel

2. **POOR QUALITY ORES.** High levels of impurities in Ukrainian iron ore make it difficult to introduce new technologies in the industry, while a high sulfur content in the coal prevents the introduction of coal dust aeration technologies. Among others, this will spur an increase in imported better-quality Russian iron ore and coking coal.

3. **LOW PRODUCTIVITY.** Productivity among steel industry workers is low by world standards. This is partly due to the outdated technology being used, which has not changed radically since soviet times.

⁷⁷ Soft budget constraints were the result of close ties between Ukraine's steel barons and the Government. Among others, this allowed steel mills to get natural gas and electricity at unreasonably low rates, to privatize state enterprises at below market value, and to have other breaks.

4. **PERSISTENT TRADE BARRIERS.** Ukraine is 13th in the world for the number of anti-dumping actions taken against it: a total of 51 suits were filed between January 1995 and June 2004. Exports of milled steel to EU countries are restricted by a quota, while Russia has been restricting imports of both Ukrainian milled steel and pipes.

Trends in the steel trade

Ukraine's steel exports grew substantially over 2002 – 2004, when world prices began to grow significantly. In 2004 alone, income from steel exports grew 60%, to US \$10.8bn, fully one third of all export in Ukrainian goods. The lion's share of this export goes to Asia, Africa and the Middle East, while access to the EU and US markets is restricted through quotas and duties.

Today, steel products are the most important item in trade between the EU and Ukraine. In 2005, Ukraine exported steel products worth US \$1.95bn to the EU, making it one of the EU's leading importers of steel. Ukraine would like to expand its presence on European markets in order to reduce its current dependence on Asian ones.

Given the domination of mini-mills around the world and the efforts of developed countries to offshore those phases of the manufacturing process that are highly polluting, the low added value of Ukrainian exports of steel products is compensated by strong external demand for steel products. Steel mills in those countries that joined the EU in 2004 traditionally depended on supplies of Ukrainian iron ore, coke and steel products. This means that the different production structures in Ukraine and the EU will lead to the development of intra-sectoral trade.

Obviously, the future of Ukraine's steel industry will firstly depend on whether the sector can adapt itself to world trends towards higher energy prices and reprocessing metal products. In the short term, we expect certain trends in trade between Ukraine and the EU to continue:

- Ukraine will remain a net exporter in the trade in steel products with the EU;
- the share of semi-finished steel products will continue to play a major role in Ukraine's export volumes, based on the current profile of Ukraine's capacities and expected high demand in the EU for this kind of product;
- the EU will keep its anti-dumping duties against Ukrainian pipes (see brief on trade restrictions in [APPENDIX 6](#)).

Prospects for Ukraine–EU cooperation

Most tariff barriers in trade between Ukraine and the European Union will be dropped as soon as Ukraine accedes to the WTO and Ukrainian producers begin to buy milling facilities in the EU:

1. **WTO ACCESSION.** This is the first step to strengthening the position of Ukrainian steelmakers on external markets. One positive result of WTO accession for this sector will be the cancellation of EU quotas on imports of Ukrainian milled steel and the option of taking advantage of mechanisms to regulate trade disputes with other parties.

2. **INTEGRATION BETWEEN UKRAINE AND EU STEELMAKERS.** The relatively slow pace of capital investment by Ukrainian companies was compensated, until recently, by their active international expansion.⁷⁸ This strategy, among others, reflected the companies' desire to get around the EU's restrictive quotas and to enter the European market for finished steel products. Another example was the merger of Mittal Steel and France's Arcelor, which made KryvorizhStal part of the world's biggest steelmaker, with assets all over the globe.

However, if Ukraine's steel industry does not modernize, in the medium term domestic steelmakers are likely to lose market share in the EU to China or another country that becomes a low-cost and hi-tech steelmaker.

In short, competition for the EU market will grow stronger on the part of both European companies and other major exporters to the EU:

EUROPEAN STEELMAKERS. The EU's steel industry has clear technological advantages and better access to major European steel buyers. In addition, the EU will put even more effort into ensuring a level business playing field at the same time as trade liberalization makes it possible for Ukrainian companies to fully take advantage of their competitive edge in terms of lower production costs. Most likely, European steelmakers will carefully monitor any possible instances of unfair competition and will initiate further anti-dumping, special and compensational investigations against Ukrainian companies at the WTO.

COUNTRIES THAT EXPORT STEEL. This is primarily Turkey and Russia, with China and India also investing actively in developing this sector. Today, Russia, which has a number of advantages over Ukraine's domestic steelmakers is

⁷⁸ Ukrainian financial-industrial groups (FIGs) own four steel plants and a slew of wholesale and retail steel traders in Europe: in Italy, Poland, Hungary and Switzerland.

one of Ukraine's main competitors for the EU market.⁷⁹ The other major steel exporter to the EU, Turkey, is already highly integrated in this sector with the Union, thanks to a customs union between the two. Turkish steelmakers and their national steel association are associated members of the European Confederation of Iron and Steel Industries, EUROFER.

Ways and means of cooperating

The steel industry is possibly the one sector in many countries that is very sensitive and for that reason it is often included in Free Trade Area agreements. Indeed, the union of steel and coal markets was the first step to forming the European Union. Obviously, the steel industry is extremely important for Ukraine's economy, which is why it is important to anticipate forms of cooperation that will benefit both sides. In our opinion, signing an FTA agreement between Ukraine and the EU could become a major factor spurring the domestic industry to modernize, ensuring that the EU cannot introduce trade restrictions on Ukraine, and continuing integration processes at the company level.

Among others, the agreement should anticipate the gradual harmonization of Ukrainian legislation with that of the EU in those areas where lack of reforms has distorted conditions for trading in steel products. Reforming the way it regulates its economy is more important for Ukraine than even the cancellation of duties in the context of an FTA: import duties on Ukrainian products entering the EU have already been lowered, on average, to only 3%.

Below, we present a number of problems with fostering the development of steel trading with the EU in this sphere that, in our opinion, are very current. That is followed by proposals for policy changes that would appeal to Ukraine's steel industry:⁸⁰

- competition and state aid;
- investment climate and financial services;
- environmental protection;
- energy.

Another important form of interaction between Ukraine and the EU is negotiating among sector associations. It is worth raising the capacity of Ukraine's associations to regulate disputes with EUROFER before transferring them for review at the government level. If interbranch agreements can be reached,

⁷⁹ Russian companies have a number of advantages over Ukrainian ones: 1) lower energy costs; 2) more modern steel-making facilities; 3) joint production projects with European companies.

⁸⁰ In 2005, the Ministry of Justice published a detailed analysis of the progress of adapting domestic legislation to EU requirements in these areas in a study called "Review of the state of adaptation of Ukrainian legislation to the *acquis communautaire*."

they will have a positive impact on the foreign policies of the two sides, as the policies of both the Ukrainian Government and the European Commission take into account the country's commercial interests.

The EU and Croatia⁸¹

Protocol 2 on steel products attached to the FTA agreement between the EU and Croatia is typical and provides, among other, for:

1. Mutual cancellation of import duties on metal products, with a five-year transition period on certain products, and restrictions on volumes.
2. Croatia's introduction of the programs needed to restructure the steel industry over two years in order to make the sector viable under market conditions. At the request of Croatia, the EU may provide appropriate technical consultations.
3. Croatia's offer of state aid to restructure the sector over five years after the institution of the FTA. This is allowed, among others, by:
 - assistance will make existing companies more viable under free market conditions after restructuring;
 - the volumes and depth of the assistance will be severely limited only to what is needed to revive the viability of the companies and will gradually be cut back;
 - the restructuring program will be accompanied by optimization and cutbacks in production capacities in Croatia.
4. The two sides to ensure complete transparency in carrying out the necessary restructuring program through full and ongoing exchange of information, especially as regards the volumes, intensity and purpose of state assistance.

State aid

Since 2003, when the economic pilot program in the metals and mining complex was halted, the steel industry no longer has any tax breaks. Still, there are other forms of government assistance in the sector, which provides the grounds for the EU to establish trade barriers:

1. **STATE REGULATION OF PRICES AND TRADE PROCESSES FOR RESOURCES THAT ARE KEY TO THE STEEL INDUSTRY.** This includes efforts to balance the distribution of iron ore and other raw materials and the establishment of export duties on scrap metal. The latter will be gradually cancelled after Ukraine accedes to the WTO.

2. **FEC SUBSIDIES FOR COAL INDUSTRY, POWER UTILITIES AND OIL AND GAS COMPLEX.** Some subsidization is involved, but mostly it is state aid in the form of enor-

⁸¹ A Stabilization and Association Agreement between the European Communities and their Member States, on the one part, and the Republic of Croatia, of the other part.

mous, unstructured loans to fuel and energy complex (FEC) companies and below-market rates and prices.

Since the first issue will most likely be resolved within the WTO framework, the reformation of the FEC becomes the main task that needs to be undertaken to protect Ukraine's steel industry against possible trade sanctions being imposed by the EU or other WTO members.

Reforming the policy of state aid according to EU norms is also in the interests of this sector. Given the very energy-intensive nature of the domestic steel industry, further increases in the price of natural gas in combination with a slowdown in world prices for steel could lead to a financial crunch in this sector and to greater demand for state aid. However, in contrast to most countries, where the restructuring of the steel industry took place with the active participation of the government, Ukrainian steelmakers will not likely be able to count on this kind of support or on a transition period (see [APPENDIX 7](#)).

This means that the only way to get state aid that will not be seen as distorting conditions for competition would be to change the nature of state aid in Ukraine in favor of ancillary goals: environmental protection, R&D and regional development.

Current state aid policy in Ukraine is ineffective because public resources are scattered among sectors and spending is poorly controlled. Related legislation does not meet EU norms. Specifically, the Law "On state aid" has not even been approved to date. Planned changes to the Law "On protecting commercial competitiveness" include a definition of state aid. However, according to members of the Anti-Monopoly Committee, the issue of open access to information about the volumes of support and the procedures and criteria for getting it has not been resolved yet. One option is to include these issues in the Agreement on a Free Trade Area.

Harmonizing environmental rules and regulations

International trade in greenhouse gas emissions offers considerable opportunities both for Ukraine and for the EU, especially if the Kyoto Protocol is considered. According to the Protocol, participating countries have the right to trade greenhouse gas emissions credits and undertake joint projects directed at reducing emissions of such gases. Because its current level of emissions is lower than the norm established for the country in 1990, while the low level of efficiency of Ukraine's steel industry makes investing in energy-efficient technologies worthwhile, Ukraine is in a position to take advantage of both schemes.

EU steelmakers could meet their own emissions targets by using Ukraine's potential for reducing such emissions in accordance with the mechanism written

into the Kyoto Protocol. Ukraine's current low level of emissions also makes it attractive to move a moderate amount of EU steelmaking capacities here.

The mining & metals complex is the second worst, after the FEC, for causing air pollution in Ukraine. With the start of the economic upswing in 2000 – 2004, the situation with environmental pollution has worsened in Ukraine, although the current level of emissions remains below 1990 levels.

The current practice of establishing permissible norms for concentrations of harmful emissions is not providing incentives to reduce the level of pollution in Ukraine. Moreover, fines and fees for polluting above the established limits are financially insignificant for guilty companies.

Unlike Ukraine, environmental regulation in the EU is unusually strict and burdensome for businesses that cause pollution. The European Confederation of Iron and Steel Industries, EUROFER, says that the levels of CO₂-equivalent greenhouse gases can be reduced only by cutting back on the level of production because actual industrial CO₂ emissions are already at the theoretically lowest possible threshold. EUROFER says that, for technological and economic reasons, there is little room for improving the situation in the future.

A number of factors get in the way of cooperation between EU steelmakers and Ukrainian ones in terms of environmental protection. Unlike the EU, Ukraine does not have a domestic program for trading in greenhouse gas emission credits and, thus, lacks the institutional and technical capacity to institute and operate the necessary instruments. In addition, until recently, the international market for trading in coal emissions was not even operational. It is expected that active trade in credits around the world will begin over 2007 – 2008. All in all, EU countries and businesses are interested in investing in Ukraine in order to take advantage of the Kyoto Protocol mechanisms.

The FTA+ impact on the steel industry

For Ukraine to comply with conditions in the FTA+ agreement, as the case with the WTO, will bring both positive benefits and specific losses for different stakeholders. In particular, there are likely to be considerable costs for the Government and for businesses in the sector in terms of reducing the negative impact of production on the surrounding environment. Changes in rating policies and in state aid also mean that profits and incomes will be redistributed between the mining & metals complex and the fuel & electricity complex. This makes it important to identify the main interest groups, assess the impact of signing the FTA, and discuss various policy options in order to determine the depth and pace of adaptation in spheres that are key to the development of the steel industry.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian steelmakers	<p>Avoiding trade restrictions</p> <p>Expanded market presence in EU through further integration of operations</p> <p>Incoming investment, especially in the form of joint projects to institute Kyoto Protocol</p> <p>Upgrading facilities</p>	<p>Sharp rise in production costs due to greater costs of raw materials and environmental protection measures</p>
EU steelmakers	<p>Lower costs and opportunities to meet strict EU environmental standards by outsourcing energy intensive stages of steel making process to Ukraine</p>	<p>Growing competition due to the zero duty on imported milled steel</p>
Iron ore producers and scrap traders	<p>Growing prices on domestic markets and better access to foreign ones</p>	
FEC	<p>Better financial position as prices go up and investment comes in in response to the Kyoto Protocol</p> <p>The freeing up of cash through debt restructuring and greater fiscal discipline</p>	<p>Fewer subsidies</p>
Regional governments and companies	<p>Budget revenues to cope with unemployment and measures to protect the environment</p>	
Government/officials	<p>Instituting sectoral policies that meet EU standards</p> <p>More efficient and productive use of Budget resources in the FEC</p>	<p>Fewer Budget receipts from export duties</p> <p>The need to approve appropriate state programs and legislative/regulatory documents</p>



The energy sector

After the steel industry, Ukraine's energy sector is the second most important for trade with the EU. As a result, there is already a high level of cooperation between the two sides. The greatest trade potential is in developing cross-border electricity markets and gradually establishing a unified power market.

This section looks at the prospects for Ukraine's energy sector in the context of a Free Trade Agreement with the EU, with particular focus on:

- *possible forms of cooperation between Ukraine and the EU in policy matters to harmonize Ukrainian legislation and increase the competitiveness of Ukraine's energy sector;*
- *the impact of provisions in the Agreement on sector interest groups.*

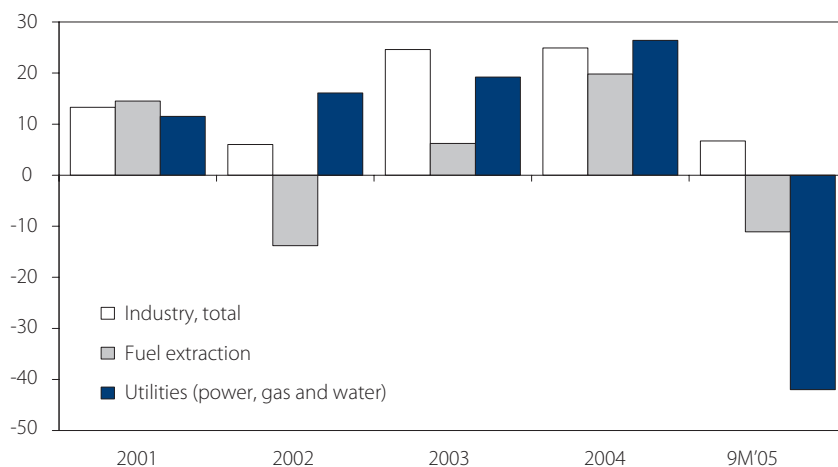
A brief overview of the energy sector

Power, the oil and gas complex and the coal industry form the backbone of Ukraine's fuel & electricity complex (FEC). Historically, Ukraine's FEC has been highly dependent on imported fuels (natural gas, petroleum, nuclear fuel) and energy-intensive. The main impediments to the growth of the power sector in Ukraine are:

- worn-out equipment and infrastructure in the power industry and oil&gas complex;
- incompatible prices and rates for fuels;⁸²
- low-grade products, especially coal and power;
- safety standards at atomic energy stations (AESs) that do not meet international standards.

Chart 12. Investment in fixed assets

% annual change



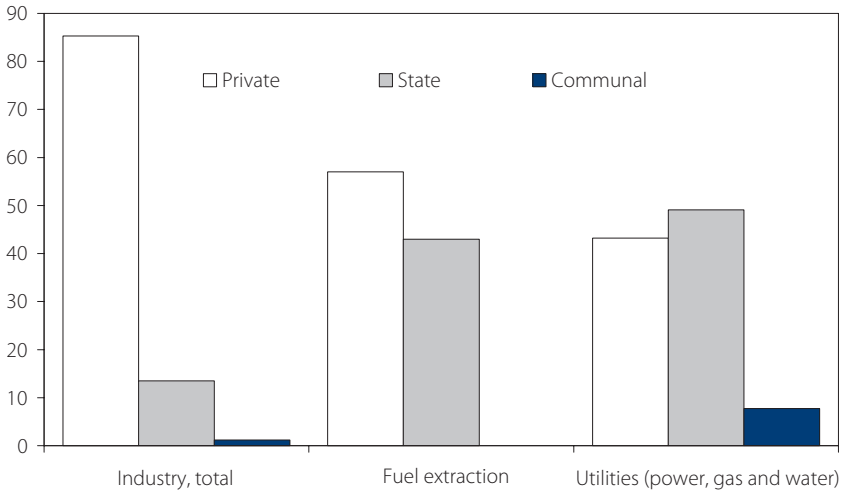
Source: Derzhkomstat

Growing energy costs and anticipated shifts in the energy balance will require a shift in state policy. Because of the long investment cycle, slow growth in capital investment in the FEC over 2001 – 2005 means that enterprises will be unable to quickly increase the extraction and production of energy or to significantly raise their efficiency levels.

⁸² Ukraine's electricity rates remain much lower than world levels. For comparison, the average EU price for electricity in 2005 was EUR 0.127/kWh, whereas in Ukraine it was EUR 0.030.

Continuing restrictions on the involvement of private capital in the energy sector and burdening of companies with social functions have contributed to a deteriorating financial position for many of them.

Chart 13. Sales by form of ownership, 2004, %



Source: Derzhkomstat

Priority areas of cooperation with the EU

Ukraine and the EU are already actively cooperating in the energy sector. Not long ago, the first results were published of the efforts of five joint working groups on nuclear safety, transport and supply of hydrocarbons, reforming the energy market, integrating power and gas markets, energy efficiency, climate change, and renewable sources of energy.⁸³

The most promising areas of cooperation between Ukraine and the EU in this sector are:

1. **INTEGRATING ELECTRICITY MARKETS.** The gradual formation of a unified electricity market or the development of cross-border electricity markets through joint financing of priority infrastructure projects and harmonizing the regulatory environment.
2. **NUCLEAR SAFETY.** Getting investment to extend the lifespan of AES blocks and improving the safety levels of their operations according to international standards.
3. **RESTRUCTURING THE COAL INDUSTRY.** Providing state aid to the sector in such a way that does not violate Ukraine's international commitments and is in the interests of regional development.
4. **TRANSIT AND SUPPLY OF NATURAL GAS AND PETROLEUM.** Increasing the efficiency and reliability of transit of Russian gas on the territory of Ukraine, as well as reforming the domestic gas market by harmonizing the regulatory environment, similarly to the electricity market.

Establishing a Deep Free Trade Area (FTA +) and harmonizing national legislation with the EU's energy *acquis* would encourage not only a deeper two-way partnership and expanded trade in energy, but also carrying out reforms that would make the sector more efficient and competitive. Thus, in contracts with the MoU between the EU and Ukraine regarding cooperation in the energy sector, which "reflects only political intentions without implying any kind of legal commitments whatsoever," the format of the Deep Free Trade Agreement will contain clear timeframes and other conditions for carrying out the agreed provisions.

⁸³ See the joint report on the first year of implementing the Memorandum of Understanding between the EU and Ukraine regarding cooperation in the energy sector.

World experience

*EU–Poland*⁸⁴

Cooperation shall be undertaken according to market economy principles in order to integrate the markets of Poland and EU countries and shall focus on:

- modernizing infrastructure;
- strengthening and diversifying energy supplies;
- drafting and planning energy policy;
- management and education in the energy sector;
- gaining control over energy resources;
- promoting energy conservation and energy efficiency;
- the impact of producing and consuming energy on the environment;
- the atomic energy sector;
- electricity and gas, particularly the possible unification of energy systems;
- establishing basic conditions for cooperation among companies in the sector;
- transfer of technology and know-how;
- greater transparency on the energy market and promoting transit gas and electricity.

*EU–Jordan*⁸⁵

Priority areas of cooperation:

- promoting renewable sources of energy and locally-available fuels;
- promoting energy conservation and energy efficiency;
- applied research, particularly to establish a data base on socio-economic sectors that link interested parties in EU countries and Jordan;
- support for modernization and the development of energy networks that can be linked to EU networks.

The main focus of cooperation will also include promoting transit gas, petroleum and power.

*EU–Chile*⁸⁶

The goal of cooperation is to consolidate economic relations in such key sectors as hydroelectric power, petroleum and gas, renewable energy, energy-saving technologies, and rural electrification. In particular, this means:

⁸⁴ This Free Trade Agreement lost force when Poland joined the EU.

⁸⁵ Euro-Mediterranean Agreement establishing an Association between European Communities and their Member States, of the one part, and the Hashemite Kingdom of Jordan, of the other part.

⁸⁶ Agreement establishing an Association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part.

- exchange of information in all suitable forms, including establishing joint databases for the institutions of both sides to the agreement, workshops and conferences.
- technology transfer;
- diagnostic training, comparative analysis and the implementation of programs by the institutions of both Chile and the EU;
- engaging state and privately-owned enterprises from both regions in technological development and joint infrastructure projects, including third country networks in the regions;
- where appropriate, signing specific agreements in key areas that represent common interests;
- assistance to Chilean institutions in solving energy issues and developing energy policy.

The energy sector and Eurointegration

Trade in energy resources between Ukraine and the EU has not fully been liberalized yet. Ukraine's mostly private companies in the natural gas extraction or power generation business have no opportunities to sell these outside the country, including exporting to the EU. On the other hand, there is considerable likelihood that Ukraine will place restrictions on the import of coal and petroleum products⁸⁷ in order to support domestic producers. Yet, the biggest impediment to the expansion of trade between the two sides is the gap in technical and other standards and the rules governing their power markets.

Harmonizing power regulation⁸⁸

Changes on the market

Ukraine's power market underwent active reforms in 2004. Among others, the British pool model was chosen as a template for establishing the terms of operation on the domestic market and for setting up a regulatory body.

Over 1998 – 2001, a slew of oblast power utilities were privatized. But further privatization tenders were put on hold because of the lack of payment discipline and low electricity rates.

In the last few years, the power market has seen growing state interference and a slowdown in inflows of private capital. For instance, in 2004, the Government gave the rest of the state's assets in this area to a vertically integrated entity called Energy Company of Ukraine or NAK ECU. This decision went against the underlying principles in electricity market reforms in Ukraine.⁸⁹

The market model in Ukraine today consists of a single electricity buyer, which means a complete absence of competition on the wholesale electricity market. It also means that power generating companies cannot directly sign contracts with consumers or retail suppliers.⁹⁰

⁸⁷ Ukraine imports these products from some EU countries, including Poland and Lithuania.

⁸⁸ Here and further, this report makes use of materials from the study "Power reforms in the EU: A model for Ukraine!" by the Institute for Economic Research and Political Consultations in 2006, from a report called "The Prospect for Deep Free Trade between the EU and Ukraine" by CEPS and ICPS, and Ukraine's Energy Strategy to 2030, the chapter called "Integration into the EU: Legislative and normative support for expanding electricity markets and liberalizing the FEC."

⁸⁹ It also contradicted EU requirements to demonopolize power generation, power distribution and power supply vertically, in accordance with Directive 2003/54/EC.

⁹⁰ The Ukrainian electricity market works thus: power generators put price bids into a common pool, out of which retailers and certain major consumers make their purchases.

The wholesale market operator, a state company called EnergoRynok, balances supply and demand and sets wholesale prices. For some power generating companies, prices are regulated. On the other hand, heating plants can bid independently, which maintains a certain level of competition.

The market is regulated by the National Electricity Regulatory Commission (NERC), which, among others, licenses the operations of natural monopolies and establishes rates. Ukrinterenergo, which is part of NAK EKV, handles exports, which controls access to the grids that link Ukraine with neighboring countries. Since it has spare power, Ukraine is able to export electricity to Moldova, Poland, Russia, Romania, Slovakia, and Hungary (see trends in electricity exports in [APPENDIX 9](#)).

Compliance with EU requirements

Comprehensive reform of the power sector in Ukraine by harmonizing with EU legislation and provisions should be made part of the strategy of deeper free trade. The power sector is one of the main service industries where the EU *acquis* suits Ukraine well. The main legal documents in the EU *acquis* regarding the power sector are:

- Directive 2003/54/EC of 26 June 2003 regarding common rules on the domestic power market.⁹¹
- Regulation 1228/2003 of the European Parliament and of the Council of 26 June 2003 regarding terms of access to networks for cross-border flows of electricity.
- Directive 2005/89/EC of 18 January 2006 regarding measures to secure electricity supplies and investment in infrastructure.
- Decision 1229/2003/EC of the European Parliament and the Council of 26 June 2003 on the rules for trans-European power grids.

The EU's internal rules largely correspond to best international practice. They were developed to reach specific goals: liberalized markets and cross-border integration. According to EU "energy directives," common market policy is aimed at:

- vertical demonopolization among generators, distributors and suppliers of electricity;
- ensuring non-discriminatory access to power grids for consumers;
- transparent market regulation through independent regulators;
- gradual liberalization of all segments of the energy market.

⁹¹ Among others, this Directive requires the demonopolization of the market, non-discriminatory access to the power lines, the gradual opening of the market, and the institution of regulatory bodies by all EU Member States.

Liberalizing the EU energy market

EU legislation requires gradual liberalization of electricity (and natural gas) supplies.⁹² Still, different EU members are carrying out the provisions of the energy *acquis* to different degrees.

After nearly 10 years of reform, the Italian, Irish and French markets remain in the hands of a group of companies and are poorly integrated with the energy markets of other countries. In Austria and Germany, the requirement to demonopolize vertically has only partly been implemented and conditions to guarantee the non-discriminatory access of third parties to power grids remain inadequate. In some of the newer member countries, such as Estonia, Poland and Hungary, the “social” approach to regulating end-user prices and the widespread practice of long-term contracts are the main barriers to competition and investment inflows in these markets.

Great Britain, Denmark, Norway, Finland and Sweden have instituted these EU Directives the most fully. Scandinavia has successfully established a unified, competitive electricity market called Nord Pool.

Compared to the requirements of the EU *acquis* regarding the energy market, the Ukrainian electricity market can be assessed thus:

1. The requirement for vertical demonopolization is only partly being satisfied, as distribution and retail sales of electricity remain combined.
2. The practice of cross-subsidization of rates for residential users is against EU requirements, based on which low-volume users should pay more than large-volume users.
3. The inability of power generating companies to independently arrange contracts with consumers, especially foreign ones, continues to be the main barrier to investment and the arrival of new players on the market, and thus to competition.⁹³
4. The institutional capacity of the NERC is weak, while the lack of a proper legal base for its activity makes for a high degree of unpredictability in its regulatory decisions.

Possible measures and forms of cooperation

Measures that would foster Ukraine's further integration into EU energy markets could include:

1. Stopping the practice of cross-subsidizing rates for residential consumers.

⁹² As of 1 July 2007, all consumers, including residential ones, in EU Member States must be able to exercise their right to choose a power (and gas) utility.

⁹³ EU practice shows that a predominance of long-term contracts on the market can restrict competition, which is why conditions need to be set up for spot-trading in electricity.

2. Switching from a single-buyer model to a model of direct consumer contracts⁹⁴ and introducing regulated access to transport and distribution networks.
3. Separating the distribution and supply of electricity, possibly within the framework of a single company.
4. Privatizing power generation and distribution companies, which will make it possible to upgrade infrastructure and expand cross-border trade.
5. Strengthen the institutional capacity of the NERC to regulate impartially on a legislative basis and engaging technical assistance from donor organizations that have the necessary level of experience.⁹⁵
6. Adopting EU standards regarding environmental protection, nuclear safety and generated power.⁹⁶

Harmonizing and adapting technical standards

According to the Institute of General Energy under the National Academy of Sciences of Ukraine (NAS), Ukraine's FEC is governed by 2,688 interstate standards (HOST), 460 national standards (DSTU), 114 sectoral standards (HSTU), and 940 sectoral standards left over from the former Soviet Union. Nearly 62% of the 4,202 standards in effect today do not meet modern requirements and need review and revision.

According to the Institute, the cost of developing a single state standard from scratch is an average of UAH 40,000, while harmonizing to a single international one is only UAH 10,000. The expense of developing the 50 highest-priority standards in all sectors of the FEC will be about UAH 2mn, while instituting the international ones that constitute one of the conditions of accession to the EU will be UAH 7mn.

Integrating power grids

Prospects are good for Ukraine's grids to integrate into the power union governing European countries, the Union for the Coordination of Transmission of Electricity (UCTE) as early as 2009 or 2010. The EU has already approved Ukraine's application for membership in UCTE, which will allow the country to sell electricity to the EU after it has met the necessary conditions.

⁹⁴ The NERC considers it possible to switch to a market of direct contracts between power utilities and power consumers by 2008, as anticipated by the Concept for the Functioning and Development of the Wholesale Electricity Market in Ukraine. Technically, this will be possible after an automated system for commercial tracking of electricity has been introduced.

⁹⁵ Specifically, this means the coordination of efforts with successful regulators from Central European countries who recently joined the EU (Twinning projects). EU practice in instituting reforms shows that a competent regulatory body with broad-ranging powers and full independence is necessary for these rules to be instituted.

⁹⁶ This includes such important power specifications as the range of fluctuation from the established frequency (50 Hz), sinusoidal characteristics, uninterrupted power supply, and the range within which line voltage can fluctuate.

The current level of integration

The parallel operation of the Ukraine's Unified Energy System (OEC) with UCTE should be a priority for state policy, based on the Energy Strategy to 2030 adopted by Ukraine. The OEC is currently not synchronized with the European system,⁹⁷ which makes it impossible to take advantage of all the country's electricity export potential.

One consequence of this declaration of intentions was Ukraine's independent technical review of its systems in terms of determining its correspondence to UCTE standards and designating the areas and volumes of work needed technically and legally as regards domestic legislation.⁹⁸ At the beginning of 2006, the UCTE Steering Committee and General Assembly in Vienna accepted Ukraine's application to synchronize its OEC with UCTE. At the moment, the UCTE – Ukraine technical committee is being formed and it will coordinate the preparation of a list of measures related to joining UCTE and their implementation.

Ukraine has already taken the first steps on the path to integration with UCTE. In particular, it has a four-year history of parallel operations of the southwestern section of the power system, Burshtyn Island, which includes two heating plants and one hydroelectric station with an overall capacity of 1.95 GWt and 220–750 kWt lines running to Romania, Slovakia and Hungary.⁹⁹

For cross-border integration of power grids to become possible, Ukraine needs to remove all technical and institutional obstacles. Joining the European power grid will mean that parallel operations with the electrical systems of CIS countries and the Baltics will have to cease and connecting infrastructure built that will ensure technical compliance with the European network.

Further steps

If Ukraine does want to join the European continental network of power lines without leaving the CIS network, which has a different frequency, enormous investments will be needed to build new power lines with transformers to work as an adaptor between the two systems. This will also need cooperation among entities regarding the management of the system and the coordination of switches between operators of transmission systems. Among others, the Energy Strategy anticipates a number of measures to establish the technical requirements for trading in electricity:

⁹⁷ Since 2001, Ukraine's electricity system has been operating in parallel with the CIS and Baltics. Operating in a single synchronized zone makes it possible to maintain the frequency at a stable level.

⁹⁸ In addition, the European Commission has provided EUR 3mn for a project entitled "Support for Ukraine's integration into Trans-European Power Networks" through the TACIS program.

⁹⁹ The Burshtyn Island system has been modernized in accordance with UCTE requirements and meets EU standards of reliability, energy-efficiency, and quality of electricity.

- setting the level of technological standards and conditions for Ukraine's OEC to operate in parallel with the European electricity system.
- setting the timelines and funding sources for measures to institute additional regulating capacities;¹⁰⁰
- define and establish transparent, stable rules for tax and depreciation policy regarding entities directly responsible for the carrying out of technical aspects for integration with UCTE.

Ukraine also needs to show some progress in its program of internal reforms to bring rules of operation on the Ukrainian electricity market in line with European standards.¹⁰¹

Once the power lines are physically connected, it will also be necessary to run this combined system. The integration of national markets in this sector will require cross-border cooperation in regulating the system to an even greater extent than other sectors. This explains why a branched structure in a unified electricity market involves not only rules and provisions but also a powerful institutional component.

Ukraine can also gradually integrate to a number of basic EU institutions as, say, an observer:

- The Union for the Coordination of Transmission of Electricity (UCTE), for the technical coordination of connected power lines;
- The European Association of Transmission System Operators (EATSO), to maintain cross-border access to grids and trade;
- The Council of European Energy Regulators (CEER), to coordinate regulation.

Models of cross-border electricity markets

There are three main models for cross-border electricity markets. In the model based on a single wholesale buyer, which is the model currently in use in Ukraine, the authorized agency buys electricity from all generation companies and then sells it on. This model does not require demonopolization and restrains competition.

The model based on open third party access to the primary electricity market is based on more competitive trading mechanisms. The power transmission systems (power lines) are open to users (power generating companies) who are able to sell electricity to both retail suppliers and major consumers. Still, most trades continue to take place on

¹⁰⁰ Among others, to improve stability, the operating regime, and the safety of electrical supplies during emergencies through a complete reconstruction of OEC primary regulating systems—including the automatic regulating systems at TES and HES to bring their rapid action in line EU norms—, to institute automatic frequency and voltage systems, to reconstruct the equipment on electricity networks to increase their throughput, and to use the regulatory potential of electricity users who regulate frequency and voltage in the system.

¹⁰¹ For instance, the drafting and approval of a Grid Code for integrating grids.

the basis of long-term contracts. The basis for introducing this kind of model is effective regulation of access to the network. In other words, for a cross-border electricity markets to function, additional domestic reforms are needed.

The third and most complicated form of cross-border electricity markets is energy pools or wholesale exchanges. For an energy pool to operate, what is needed is a well-developed regulatory and institutional structure, such as spot and futures markets and electricity brokers. There also need to be enough producers of a similar volume to ensure proper competition. EU Member States are slowly moving in this direction.

Nuclear safety

This report looks at only the final product of atomic energy and that which can be traded two ways: electricity. For the purpose of two-way trade, atomic energy is a domestic issue that does not affect cross-border trade as such. On the other hand, the end product of this industry, electricity, is a proper commodity.

The new, enhanced Agreement between Ukraine and the EU will include not only free trade but also technical assistance (TA). ICPS analysts anticipate that the new section on TA will combine and possibly expand existing provisions in the MoU between Ukraine and the EU in the energy sphere and other bilateral documents regarding nuclear safety, environmental protection and trading in nuclear materials, and in related spheres. The bilateral base between Ukraine and the EU includes such aspects of atomic energy as:

- cooperating in combatting illegal trade in nuclear materials;
- harmonizing legislation and instituting international standards of nuclear safety;
- strengthening the institutional capacity of the State Committee for Atomic Regulation in Ukraine. This requires Ukraine to ensure that the nuclear regulator carries out its designated functions as an independent, competent nuclear safety agency;
- approving a strategy on radioactive wastes, especially the building of containers for spent nuclear fuels;¹⁰²
- working jointly to resolve issues related to the aftermath of the Chernobyl disaster.

Restructuring the coal industry

Nearly a third of Ukraine's energy balance is covered by coal, nearly double than is typical in the EU. Ukraine is one of the ten largest producers of coal in the world. Most of the country's unprofitable mines continue to be state-

¹⁰² Under the agreement to construct blocks at the Khmelnytskyi and Rivne AES, Ukraine committed itself to establish a Fund for removing nuclear objects from active use and to uphold the General Plan regarding radioactive waste and spent nuclear fuel.

owned and enterprises in the industry get state aid.¹⁰³ The steel industry's financial-industrial groups (FIGs) use coal to produce coke and, in this way, take advantage of these subsidies. Other problems in this sector are the damaging effect of the coal industry on the environment and the low level of productivity among workers because of overemployment.

One good example for Ukraine could be the strategy for reform adopted by Poland prior to joining the EU to restructure its coal industry. For Ukraine, some key measures could be:

- increasing the profitability of state-owned mines;
- cutting off subsidies to privatized mines and industrial users;¹⁰⁴
- shutting down mines that are not viable;
- eliminating overemployment in a socially acceptable manner;
- reducing the level of pollution emitted by the coal industry.¹⁰⁵

¹⁰³ The State Budget spent nearly UAH 3.6bn on the coal industry in 2004.

¹⁰⁴ Ukraine has to enshrine in law the forms, conditions and terms for providing state aid to the coal industry and establish a system for monitoring the provision and use of state aid.

¹⁰⁵ Cooperation among EU and Ukrainian companies in this area can be effected on the basis of the Kyoto Protocol.

The FTA+ impact on the energy sector

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian generators and exporters of electricity	<ul style="list-style-type: none"> Expanded exports of electricity to the EU Incoming investment to modernize production capacities Better conditions for market operation through better regulatory system (more impartial and predictable decisions by regulator) Fewer risks of restrictions on exports of "dirty electricity" to the EU 	<ul style="list-style-type: none"> Increased costs for modernizing and meeting EU standards Stronger competition and possible squeezing out of the market or being swallowed up by EU rivals Increased costs related to upholding safety standards, job and environmental protection, consumer rights
Ukrainian power utilities	<ul style="list-style-type: none"> Possibility to provide services at an economically reasonable price Fewer commercial and line losses on the network 	<ul style="list-style-type: none"> Need for structural and organizational changes because of growing competition on the power supply market
Ukrainian coal enterprises	<ul style="list-style-type: none"> Effective solutions to social problems in mining towns Higher prices for coal 	<ul style="list-style-type: none"> Stricter conditions for state funds Growing competition on the domestic market as more EU and other coal is imported
Government/regulatory agencies	<ul style="list-style-type: none"> Growing Budget revenues as electricity rates rise Better conditions for integrating into EU structures and instituting EU standards of safety and environmental protection Possibility of accessing EU resources to solve domestic issues under related assistance mechanisms 	<ul style="list-style-type: none"> Costs to harmonize legislation with EU norms
Residential users	<ul style="list-style-type: none"> Rates and power service quality that more suit their interests Higher quality power services 	<ul style="list-style-type: none"> Steep rise in rates, which, however, could be compensated by social assistance programs
Industrial users	<ul style="list-style-type: none"> Possibility to choose a power supplier and sign long-term contracts once the market is liberalized 	<ul style="list-style-type: none"> Higher rates

Part II

Cross-cutting issues



The investment climate

As a result of the deep free trade agreement between Ukraine and the EU, more lively foreign direct investment will have a significant positive impact on Ukraine's economy and will accelerate the country's economic growth and structural changes. It will also facilitate modernization and a higher level of economic stability when dealing with external challenges.

The government's commitments to implement the reforms needed to sign a free trade agreement with the EU should increase the level of trust among investors in the Ukrainian economy and reduce the "risk premium" and the cost of resources.

An FTA+ between Ukraine and the EU is not the only significant factor in determining the level of the country's investment appeal.

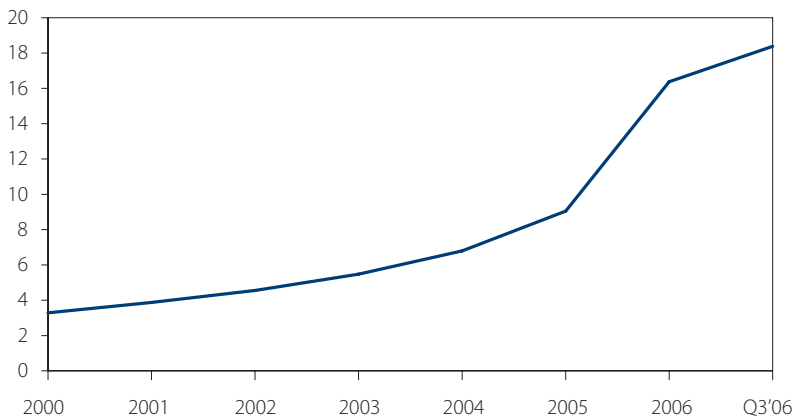
A number of non-economic factors, including political stability, also significantly influence the investment climate. However, deep free trade between Ukraine and the EU is an effective instrument that will not only improve Ukraine's access to the powerful investment resources of the European Union, but will also facilitate the implementation of systemic transformations in the country, improving the environment for doing business and the investment climate as a whole.

Investment activity in Ukraine

Since the beginning of 2005, foreign direct investment (FDI) in Ukraine has grown significantly. The net foreign direct investment made from 1 January 2005 to 1 July 2006 surpassed the net FDI invested in the Ukrainian economy in 1991 – 2004.¹⁰⁶

Chart 14. FDI into Ukraine's economy

billions USD, at the beginning of the period



Source: Derzhkomstat

Foreign investors show the most interest in:

- the steel industry;
- the financial sector;
- wholesale trade;
- the food industry and the processing of agricultural products; and
- the real estate sector.

116 countries have made direct investments in the Ukrainian economy. About 85% of those investments came from Austria, Cyprus, France, Germany, the Netherlands, the Russian Federation, Switzerland, the UK, the US and the Virgin Islands.

¹⁰⁶ According to Derzhkomstat data, foreign direct investment of non-residents in the Ukrainian economy constituted US \$18.4bn as of 1 July 2006 against US \$9bn as of 1 January 2005. From 1 July 2005 to 1 July 2006, FDI grew US \$9.3bn.

Despite the overall positive dynamic of foreign direct investment, there is a number of problems that constitute the reason why the level of FDI is much lower than its potential¹⁰⁷ and why its quality is not always high.

The rapid growth of foreign direct investment in 2005 was primarily the result of selling two large assets¹⁰⁸ whose total value was approximately US \$5.9bn, accounting for approximately 75% of the total net FDI in the Ukrainian economy in 2005.¹⁰⁹ The growth of foreign investment during the same year was not systemic and primarily can be attributed to one-time transactions. The analysis of the structure of foreign direct investment reveals that the overwhelming part of FDI is channeled not into building new companies, but into purchasing existing ones.¹¹⁰ The share of investment channeled into starting new businesses and instituting new technologies continues to be low, although this area has significant growth potential in the process of improving the business environment in Ukraine and the investment of resources in the development of purchased assets by new owners.

A serious part of foreign direct investment comes from offshore territories,¹¹¹ that is, it is largely made by way of funds earlier withdrawn from the country by domestic businesses. Out of the US \$922.5mn invested into the Ukrainian economy in Q1'06, US \$466.4mn, or more than 50% of the total FDI during this period, came from Cyprus. The dynamic of investing national capital in the country's economy is not satisfactory. The real gross accumulation of fixed capital shrank 0.3% in 2005. In addition to shrinking public-sector investment, another reason was deteriorating investment climate given Government's attempts to carry out re-privatization and insufficient protection for investor's rights.

One of the main instruments that can positively influence investment activity in Ukraine is the institution of a deep free trade area between Ukraine and the EU. In addition to the evident improvement of conditions for the Ukrainian economy to access the vast investment resources of Europe, an FTA+ will have a significant positive impact through the implementation of reforms and legislative changes aimed at the overall improvement of the investment climate and the business environment in Ukraine.

¹⁰⁷ As of 1 January 2006, foreign direct investment per capita was approximately EUR 300. In comparison, FDI per capita hit EUR 13,750 in Slovenia, EUR 9,450 in the Czech Republic, EUR 8,750 in Hungary and EUR 6,250 in Poland.

¹⁰⁸ VAT KryvorizhStal, a steel giant, and APPB Aval, a big Ukrainian bank.

¹⁰⁹ According to Derzhkomstat data, direct investment in the country's economy was US \$7.9bn in 2005.

¹¹⁰ VAT KryvorizhStal and significant agreements in the banking sector (Aval, UkrSibBank and UkrSotsBank).

¹¹¹ According to Derzhkomstat data, as of 1 January 2006, 9.5% of foreign direct investment in the Ukrainian economy came from Cyprus and another 4.2% of FDI came from the Virgin Islands.

Changes needed for an FTA+

Adjustment of the Ukrainian legislation to EU requirements¹¹²

In the process of introducing deep free trade between Ukraine and the EU, Ukrainian legislation will be adjusted to the requirements of the *acquis communautaire*. In the context of improving the investment climate, harmonization of the legislation on **corporate governance and taxes** is especially important.

Corporate governance

The issues of corporate governance and the protection of minority shareholder's rights are regulated by the following pieces of Ukrainian legislation:

1. Civil Code №435 – IV of 16 January 2003;
2. Commercial Code №436 – IV of 16 January 2003;
3. Law №1576 – XII on business entities of 19 September 1991;
4. Law №1775 – III on licensing certain types of business activity of 1 June 2000;
5. Law №959 – XII on foreign economic activity of 16 April 1991;
6. Law №755 – IV on the state registration of legal entities and sole proprietors 15 May 2003; and
7. Law №1255 – IV on the support for the demands of creditors and the registration of liens of 18 November 2003.

The fundamental principles for regulating company and business activity in the European law are written in Title III, the free movement of persons, services and capital of the Treaty Establishing the European Community.

The overall level of adjusting Ukrainian legislation on **corporate governance and the protection of minority shareholders** to the requirements of the EU is high. For the further approximation of its legislation to the legislation of the EU, Ukraine will:

- a) bring its legislation in line with the requirements of the *acquis communautaire*:
 - provisions of the Civil Code regarding the list of facts that must be included in the statute of a joint stock company by expanding this list to bring the relevant provisions in line with Council Regulation (EC) №2157/2001 and provisions envisaged by Art. 9 of the First Council Directive №68/151;

¹¹² Here, ICPS analysts used *The Review of the Progress Achieved in Approximating Ukrainian Legislation to the Acquis Communautaire* prepared by the State Department for the Approximation of Legislation.

- provisions of the law on business entities regarding the deadline for convening the general meeting that should not constitute more than six months after the end of the financial year on the basis of provisions of Art. 59 of Council Regulation (EC) №2157/2001;
- provisions of the law on business entities regarding the first general meeting that can be held at any time within 18 months from the date a company registers according to the requirements of Art. 54 of Council Regulation (EC) №2157/2001;

b) consider the following provisions of the *acquis communautaire*:

- the amendment of Art. 37 of the law on business entities or adoption of the law on joint stock companies by expanding the list of facts that must be included in the statute of a joint stock company;
- the provision on convening a general meeting based on the order of a judicial or administrative body according to part 3 of Art. 55 of Council Regulation (EC) №2157/2001;
- amendment of Ukrainian legislation or the bill on joint stock companies regarding the redemption of corporate shares by the company itself (art. 18 – 24 of the Second Council Directive №77/91/EEC).

Taxes

Ukrainian legislation will be approximated in the following areas:

- direct taxation;
- reduced taxation;
- indirect taxes: value-added tax; and
- indirect taxes: excise duty.

There has been little adjustment to Ukrainian legislation on **direct taxation**, especially the 1994 law on corporate profit tax because international aspects of taxing corporate profits were regulated at the EU level, meaning it makes little sense to reflect these aspects in Ukrainian legislation before the country has reached mutual agreements with the EU. The principles of taxing profits of small and medium enterprises in Ukraine meet the principles written into pieces of the *acquis communautaire*.

There has been little adjustment to Ukrainian legislation on **reduced taxation** related to the regulation of state aid.

Overall, **the 1997 law on value-added tax** does not contradict the requirements of the *acquis*. However, it does not include a number of provisions regulating the administration of VAT. In the process of adjusting to the requirements of the *acquis*, the scope of the law will be expanded, with due consideration for the requirements of the EU and the need to develop clear-cut rules for VAT refunds.

Ukrainian legislation on **indirect taxes (excise duty)** is built on principles that meet the requirements of the *acquis*. It is necessary to approximate various specific rules that will be brought in line with the requirements of the *acquis* by adopting the law “On amending the law on the state regulation of the production and circulation of ethyl alcohol, alcoholic beverages and tobacco products”.

The investment climate

Legislative amendments and the harmonization of the rules for doing business in Ukraine with European norms, which will take place in the process of setting up a deep free trade area with the EU, will have a significant impact on the solutions to a number of urgent and important issues that are currently obstacles in doing business effectively in Ukraine and have a negative impact on the investment climate. In the process of negotiating an FTA+ with the EU, Ukraine will regulate important problematic issues that exist within the area of corporate governance and shareholder's rights, land relations and real estate, taxation and foreign currency regulation.

Corporate governance and shareholders' rights

The existing business environment in Ukraine is described by a number of problems that create a favorable climate for corporate wars and coercive redistribution of property in favor of powerful financial and industrial groups (FIGs). The rights of investors, both foreign and domestic, are frequently violated if they do not have coercive support for their corporate interests among representatives of government bodies.

Improvement of the business climate requires an enhanced legislative regulation of a number of issues related to the protection of minority shareholder's rights and corporate governance and will be implemented in the process of signing a Free Trade Agreement between Ukraine and the EU.

Minority shareholder rights

Diluting the stakes of minority shareholders to strengthen control over the company is one of the widespread instruments that FIGs use in competition for companies and that reduce the interest of investors (both residents and non-residents) in such companies.¹¹³

¹¹³ A typical example is an increase in the statutory fund of VAT ZaporizhStal, a Ukrainian steel giant, with the help of shares of five business entities that are owned by majority shareholders of VAT ZaporizhStal. Adding assets that are dubious in terms of their value to the statutory fund of VAT ZaporizhStal reduced the stakes of minority shareholders to the minimum, what resulted in an almost 50% depreciation of the value of company shares. This was caused by a steep decline in the interest in securities of this company where majority shareholders use questionable methods to compete for property.

Another significant problem is that majority shareholders use schemes that minimize the payment of dividends. These schemes minimize the incomes from the minority shareholders' property, but do not have a negative impact on the majority shareholders who compensate low dividends with the help of unclear methods for receiving income.

The protection of minority shareholder rights must be improved on the basis of the following legislative changes proposed in the bill on joint stock companies:

- the indispensable participation of representatives of minority shareholders in supervisory councils of joint stock companies;
- the priority right to purchase corporate shares in the instance of an additional issue; and
- a guarantee for paying dividends that are not lower than 15% of the profits.

Corporate governance

- **IMPROVING PROCEDURES FOR THE MEETING OF SHAREHOLDERS TO MAKE MANDATORY DECISIONS.** The Civil Code establishes that 75% of votes are needed for the meeting of shareholders to make mandatory decisions and identifies a list of issues that can be resolved only at the meeting of shareholders. It makes sense to expand the rights of shareholders regarding the possibility for shareholders to supplement the list of such issues for their joint stock company, by common agreement, and to establish the minimum number of votes needed to adopt specific decisions.
- **REGULATING THE ISSUE WHEN SHAREHOLDERS HOLDING A 40%+ STAKE BLOCK OPERATIONS BY NOT PARTICIPATING IN SHAREHOLDERS' MEETINGS.**
- **REVISING THE DEADLINES FOR INFORMING SHAREHOLDERS ABOUT MEETINGS.** According to the legislation, each shareholder should receive the information about a meeting of shareholders at least 45 days prior to the date of such a meeting. This requirement reduces the efficiency and effectiveness of managing a joint stock company and must be revised for companies with a single shareholder and for instances when all shareholders provide a written agreement to hold the meeting within a shorter period of time.

Closed joint stock companies

The stock of companies registered in the form of closed joint stock companies (closed JSCs) are divided only among the founders of a closed JSC and cannot be an object of trade on the organized stock market. The form of a closed JSC makes it impossible for outside investors (both residents and non-residents) to purchase its shares and makes the structure of property and procedures for redistributing the stock of closed JSCs untransparent.

As of 1 January 2006, the country registered more than 33,000 joint stock companies, including almost 22,000 companies in the form of closed joint stock companies. This means that the stock of almost two-thirds of top Ukrainian companies cannot be the object of investment and their owners artificially protect it from the outside world. The bill on joint stock companies provides for the elimination of closed joint stock companies and the reorganization of all existing closed joint stock companies into open joint stock companies. This reorganization will make it possible to access investment resources through the operations of initial public offerings (IPOs).

Land and real estate

The sale of industrial assets together with the land on which they are located significantly raises their investment appeal and, thus, their price. The Land Code provides for the possibility to sell non-farming lands both to residents and non-residents. At the same time, there is a number of problematic issues that prevent the effective and efficient use of land resources by investors, namely:

- lack of regulation for the issue regarding the possibility for branches of foreign companies to purchase land;
- the inability of non-residents to purchase land parcels where unfinished construction objects are located;
- complicated and untransparent procedures for receiving permits to purchase land parcels and registering the ownership rights, which creates opportunities for systemic corruption; and
- lack of an integrated database that would contain information about land owners, concluded agreements involving land parcels, and so on.

Complicated and not transparent procedures and a high level of corruption constitute serious problems that are hampering the civilized development of the real estate market and can be a cause for fraud and overstate the value of real estate, the cost of which includes expenditures on bribes and the solution of issues.

Taxation

Despite tangible progress, there are a number of issues in terms of taxation. The solution of these issues will significantly improve the investment climate and the business environment in Ukraine. These solutions include:

- **MAKING CHANGES IN THE TAX LEGISLATION PREDICTABLE.** The effective and efficient implementation of large investment projects requires a clear understanding by investors of all factors and risks that influence the profitability of their business. It is currently impossible to evaluate the level of tax burdens on business in the medium term, holding investors back in the long term from investing their resources in the Ukrainian economy.

- **IMPROVING PROCEDURES FOR VAT REFUNDS TO EXPORTERS.** The VAT refund system must be made transparent to establish the responsibility of the state before exporters for not refunding VAT in full by the deadline specified by law. Failure to regulate this issue has reduced the investment appeal of export-oriented enterprises.
- **REGULATING TAXATION OF OPERATIONS TO PURCHASE/SELL CORPORATE RIGHTS.** The procedures for taxing operations to purchase/sell corporate rights without using securities (for example, purchasing a stake in a limited liability company) are not clearly written into the legislation unlike the operations to purchase/sell corporate rights through acquiring securities (shares). The State Tax Administration (STA) uses a lack of clear-cut legislature to its advantage to charge such operations with value-added tax.
- **CANCELING FEES TO THE PENSION FUND THAT ARE COLLECTED FROM EXCHANGE OF NON-CASH CURRENCY.**
- **ESTABLISHING CLEAR-CUT PROCEDURES FOR ACCOUNTING THE GROSS EXPENDITURES OF COMPANIES MADE IN FOREIGN CURRENCY.** Ukrainian legislation does not outline a clear-cut procedure that would indicate what exchange rate should be used to identify gross expenditures: the exchange rate of the National Bank on the date of declaring profits, the exchange rate of the interbank market, etc.
- **IMPROVING THE PROCEDURES FOR NON-RESIDENT INDIVIDUALS TO PAY PERSONAL INCOME TAX.**

The solution of these issues that will be implemented in the process of instituting deep free trade between Ukraine and the EU will have a positive impact on the creation of a more favorable environment for domestic businesses and will make Ukraine more attractive for investment (both foreign and domestic).

Foreign exchange regulation

Setting up an FTA+ between Ukraine and the EU requires significant measures aimed at the gradual liberalization of the foreign exchange market. Deregulation of the foreign exchange market will help reduce expenditures in the process of implementing investment activity and expand the possibilities for effective and efficient asset management.

In 2005, Ukraine cancelled provisions¹¹⁴ that called for the requirement of the mandatory sale of foreign currency used for investment on the interbank for-

¹¹⁴ NBU Resolution №482 "On approving the regulation for foreign investment in Ukraine in the pecuniary form and for returning foreign investors their investment and also repatriating profits, incomes and other funds received from investment activity in Ukraine."

foreign exchange market. Currency conversion raised the cost of foreign investment as a result of paying fees to the Pension Fund, additional commission payments to authorized banks and exchange rate losses.

Developing a system for hedging exchange rate risks emerging at the time of investment and canceling mandatory sale of foreign currency by exporters are important steps to improve the investment climate that have been undertaken in Ukraine.

A number of measures aimed at improving the regulation of the foreign exchange market and the capital market that are important in further improving the investment climate will be implemented in the process of setting up an FTA + :

- **GRADUALLY REDUCING AND CANCELLING THE FEE TO THE PENSION FUND** that emerges at the time of carrying out operations to purchase/sell foreign currency.
- **SIMPLIFYING PROCEDURES FOR ISSUING LICENSES TO RESIDENTS FOR PURCHASING SHARES OF UKRAINIAN COMPANIES FROM NON-RESIDENTS.** The need to license these operations is the result of the fact that domestic businesses broadly use the mechanisms for withdrawing capital abroad through purchasing "junk shares". At the same time, overly regulated procedures for non-residents to sell shares of Ukrainian companies to residents complicate the escape of law-abiding investors from the Ukrainian market, which reduces the investment appeal of the Ukrainian business.
- **REGULATING THE SYSTEM FOR USING SECURITIES AS COLLATERAL FOR LOANS.** Existing legislation does not make it possible for creditors to block the movement of pledged securities owned by borrowers, which violates creditor's rights.
- **PROVIDING A POSSIBILITY TO INVEST FINANCIAL RESOURCES INTO THE UKRAINIAN ECONOMY IN CURRENCIES THAT ARE NOT INCLUDED IN GROUP 1 OF THE NBU FOREIGN CURRENCY CLASSIFIER.**¹¹⁵

¹¹⁵ NBU Resolution №34 determined that Group 1 of the Foreign Currency Classifier consists of freely convertible currencies that are broadly used to make payments under international transactions and that are sold on major foreign exchange markets around the world.

The FTA+ impact on the investment climate

The impact on the economy as a whole

The expediency and effectiveness of instituting deep free trade between Ukraine and the EU in the context of improving the investment climate is evaluated primarily by the impact of consequences of such an FTA+ on the country. ICPS economists will analyze the consequences of setting up an FTA+ in three main areas:

- economic;
- social;
- environmental.

The set of measures to improve the investment climate along with setting up an FTA+ will not have a direct impact on the **quality of the environment**. However, it can have an indirect impact by developing production in certain sectors of the economy that will be the priority for investing resources.

The main areas for foreign investors to invest their resources are the financial sector, the real estate sector, trade, food industry and the processing of agricultural products, that is, the types of activity whose development does not have a significant negative impact on the environment. The impact of investment into such industrial sectors as the steel industry, chemicals, etc. is multifaceted. The development of capacities in these sectors creates an additional burden on the environment that, however, is largely compensated by the positive impact of instituting new, safer technologies instead of outdated ones.

The **social impact** of setting up an FTA+ will depend on what economic results are achieved, as the volume of resources channeled into resolving social issues will depend directly on the national income created in the economy.

To evaluate the **economic impact** of instituting an FTA+ with the EU, we will analyze the impact on the following macro-economic indicators:¹¹⁶

- GDP;
- the Consumer Price Index;
- the exchange rate;
- savings and investment;

¹¹⁶ For economic impact assessment of the Free Trade Area between the EU and Mediterranean countries, such indicator groups were used: real income (includes GDP, Consumer Price Index, exchange rate), fixed assets formation (includes savings and investments rates, trade and current account balances), and unemployment.

- the current account of the balance of payments;
- public finances; and
- the unemployment rate.

International experience shows that the evaluation of the impact of the steps aimed at improving the investment climate in the process of setting up an FTA+ on the main economic development indicators is mainly a qualitative one. At the same time, carrying out quantitative analysis is rather problematic. An analysis of the impact of setting up an FTA+ between Ukraine and the EU is presented below.

Analysis according to economic components

Economic indicator	Impact ¹¹⁷	Description of impact
GDP	↑	Improving the business climate, enlivening business activity, growing domestic and foreign investment and cheaper loan capital will contribute to the long-term acceleration of GDP growth
The Consumer Price Index	↑	Slower CPI growth will be fostered by investment aimed at setting up new businesses and developing production. At the same time, foreign investment that is channeled into purchasing assets will increase financial resources in circulation without an adequate growth in the supply of goods and services and will form inflationary pressure (the example of KryvorizhStal) A more open economy will make it possible to absorb the pressure of growing consumption on prices. The integration of the Ukrainian and the EU markets will contribute to approximating price fluctuations on the domestic market to the EU level where CPI growth is traditionally low—at 2–2.5%
Exchange rate	↑	The institution of an FTA+ will contribute to Ukraine's transition to the regime of a freely convertible currency. Large foreign investment will have a positive impact on the establishment of the hryvnia as a hard currency, if the country rejects the system of fixed currency exchange rates
Savings and investment	↑	An FTA+ will improve access for financial institutions and business as a whole to powerful investment resources of the EU and will have a positive impact on the FDI growth and the attraction of loan capital At the same time, shrinking interest rates and growing imports will increase household consumption, which will have a contradictory impact on the level of savings and domestic investment The overall impact of an FTA+ on savings and investment will be mainly positive
The balance of payments	↑↓	Large volumes of foreign investment will result in a significant increase in the imports of investment goods, which will be a factor influencing the formation of a negative balance on the current account. At the same time, growing investment imports are not dangerous because they will be fully financed by investment resources and will contribute to strengthening the country's export potential in the long-term

>> *continued*

¹¹⁷ "↑" – positive impact; "↓" – negative impact; "↑↓" – contradictory impact; "=" – insignificant or no impact.

Economic indicator	Impact	Description of impact
Public finance	↑	Enlivened business activity, growing investment and GDP will contribute to a rise in national income and thus an increase in Budget revenues. Improved access to powerful and cheap external resources will expand the possibilities for and reduce the cost of financing a Budget deficit
Unemployment	↑↓	The growing number of jobs resulting from the overall increase in business activity will be, at the same time, compensated by the reduction of personnel that will happen as a result of the growing labor productivity

Thus, despite the existence of some negative consequences that can be and must be minimized, the overall impact of instituting an FTA + in the economy in the context of measures that will be implemented to improve the investment climate will be positive.

The impact on stakeholders

The institution of an FTA + between Ukraine and the EU will have a significant positive impact on the Ukrainian economy, specifically in the context of attracting investment. An FTA + will seriously simplify the access for Ukrainian businesses to investment resources of the EU. The adjustment of the Ukrainian legislation to the EU legislation and the creation of a more transparent and comfortable business environment, which is an important part of the process of setting up an FTA +, will have a systemic positive impact on the activity of all economic stakeholders and will raise confidence among investors. Despite the overall positive impact of instituting an FTA +, there is a number of consequences that can negatively influence the interests of specific stakeholders. The most important costs and benefits of implementing an FTA + for businesses, households, foreign investors, regulatory authorities and the economy as a whole are presented below.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Ukrainian businesses	<ul style="list-style-type: none"> Improved rules for doing business Improved business climate Improved conditions for access to investment resources Transparent mechanisms for attracting investment resources Reduced corruption Lower additional expenditures on investing resources The protection of investor rights Higher quality corporate governance Improved access to high technologies Simplified procedures for entering the EU market Simplified procedures for administrating taxes Simplified procedures for purchasing land and real estate More opportunities for effective and efficient asset management 	<ul style="list-style-type: none"> Disclosure of the structure of property (for financial and industrial groups) Changes in the organizational and legal forms of activity (for closed joint stock companies) Higher risks of losing control over business (for financial and industrial groups) Shrinking competitive advantages over foreign companies (Ukrainian companies are better adjusted to doing business in the current business environment) Higher exchange rate risks Stronger competition
Foreign investors	<ul style="list-style-type: none"> Improved conditions for doing business in Ukraine Simplified procedures for entering/ leaving the Ukrainian market Growing transparency of Ukrainian markets Lower accessory expenditures on investing resources Lower systemic risks The protection of investor's rights Reduced corruption Simplified procedures for purchasing land and real estate Simplified procedures for administrating taxes 	
Regulatory bodies	<ul style="list-style-type: none"> Improved supervision and oversight procedures Enhanced overall condition of the regulated systems Foreign knowledge 	<ul style="list-style-type: none"> Expenditures on preparing for an FTA+ Expenditures on harmonizing the legal field with EU norms Reduced influence on businesses
Households	<ul style="list-style-type: none"> Creation of new jobs Higher quality of goods and services 	<ul style="list-style-type: none"> Stronger competition on the labor market Stricter working conditions
The economy as a whole	<ul style="list-style-type: none"> Improved access to vast and cheap resources Improved business climate Growing foreign direct investment The institution of new technologies Institutional development and the development of the infrastructure Improvement of Ukrainian legislation Higher competitiveness of the country's economy 	<ul style="list-style-type: none"> Growing dependency on external factors An increase in bankruptcies among those who will not stand a more severe competition Higher exchange rate risks Shrinking Pension Fund revenues



State aid

Anti-monopoly policy and state aid have a significant impact on the development of trade in goods and services. Government support of companies, sectors and regions often leads to anti-dumping probes and to restrictive quotas on imported goods on the part of the country's trading partners. Therefore, common policy principles in this area would establish the conditions for a quick, effective solution to controversial issues in trade between Ukraine and the EU.

This chapter analyzes possible forms of cooperation between Ukraine and the EU in the provision of state aid within the context of a Deep Free Trade Agreement, including:

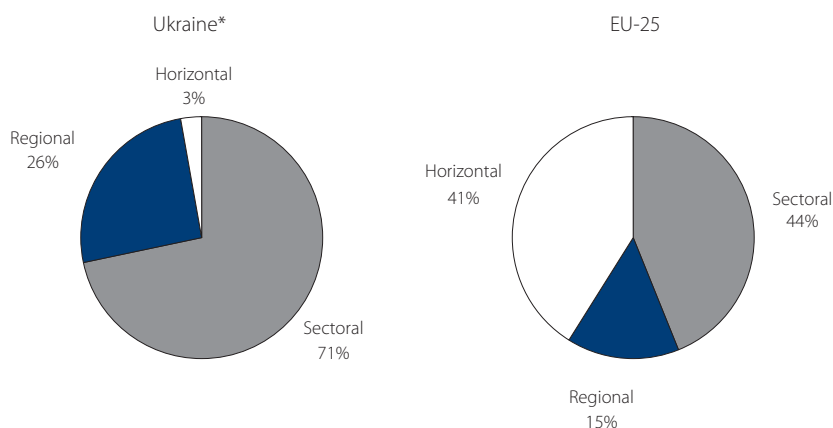
- *possible forms of cooperation that would help increase Ukraine's competitive advantage;*
- *interest groups and the impact of FTA provisions regarding state aid.*

State aid practice in Ukraine

Structure and scope

The absence of a formal definition of state aid in Ukraine makes it difficult to evaluate its scope and effectiveness. Direct state aid, in the form of tax breaks and targeted financing, is the most transparent kind, since its scope is determined by the Budget and is being overseen by the Ministry of Finance. It is more difficult to determine the scope of indirect assistance, which can take such forms as state guarantees or subsidized prices and rates. Moreover, nearly all branches of the economy¹¹⁸ receive this type of state aid.

Chart 15. The structure of state aid



*Aid given to industry in 2002

Sources: CASE-Ukraine, Eurostat

The scope of tax breaks provided over 2000 – 2005 for various sectors and regions is shown in **TABLE 10.1** (see **APPENDIX 10**). Since it is precisely assistance to economic sectors, and in some cases to regions, that distorts terms of trade, a change in policy on this kind of assistance will affect how successfully the free trade area between Ukraine and the EU actually operates. Although tax breaks are the most common form of state aid structure in Ukraine, the latest anti-dumping probes launched by the European Union against domestic pipe makers claimed that these companies had their energy bills subsidized, indicating the importance of reforming indirect types of state aid as well.

¹¹⁸ The main beneficiaries of reduced rates for power and gas is the general population of Ukraine, Budget-funded organizations and residential services providers.

A number of sectors in the machine-building industry saw their benefits significantly reduced in 2005 and special investment activity programs were cancelled. This was done to: 1) speed up Ukraine's accession to the WTO; 2) end ineffective use of public funds; 3) reduce the Budget deficit. According to Ministry of Finance calculations, dropping the most common breaks offered in special economic zones (SEZs) and territories of priority development (TPDs) increased Budget revenues by UAH 700mn, while withdrawing benefits for various branches brought in another UAH 20mn.

Policy issues

The current system of state aid in Ukraine is untransparent and ineffective for three main reasons:

- the criteria for illegibility are not clearly defined in such critical sectors as, for example, the coal industry;
- no clear rules about which investment projects might be eligible for assistance;
- no established penalties for violating the conditions under which assistance is provided, so state aid offers little in the way of results.

Ukraine's SEZs and TPDs were a classic example of good ideas in support of regional development implemented in the wrong way. State aid in the car-making industry is an example of poorly chosen priorities. Moreover, although this segment had tax breaks worth billions, the inconsistency of state policy, with benefits being withdrawn and renewed several times, made life difficult for investors.

Both the government and the companies that traditionally receive state aid understand the importance of making state aid policies more effective. Representatives of other branches, such as the steel industry, no longer ask for state aid, since that would bring negative consequences in the form of trade restrictions. Moreover, because of commitments it has made in the WTO, Ukraine's Government should start reforming of the state aid system now.

What producers say about policy issues

Agriculture

Ukraine could be a strong competitor among European producers, in particular where grain crops are concerned. Last year's ban on the import of dairy products into Russia indicated the importance of the greatest freedom of access to other, especially EU, markets.

The current situation in Ukraine is not promoting the development of agricultural segments and the meat and dairy processing associated with it. Domestic farming

is gradually losing its competitive advantage. The main problem with state policy in this area is the nearly complete absence of investment in infrastructure and education, resulting in an educational system that is inadequate for the farm sector.

State funds are often directed at inefficient companies or simply never reach the addressees. In addition, according to data from agribusinesses, 75% of the assistance goes to only 6% of the producers. Little is being done to develop SMEs in rural areas, which causes higher unemployment.

Car-making

State aid to car-making in Ukraine has generally been successful. However, it was mostly provided through benefits and special regimes, and not through targeted support, as in farming, or through state grants, as in the EU. Ukrainian companies are working in worse conditions than their EU counterparts, particularly in terms of the technical level of vehicles and opportunities to borrow. Greater integration of Ukrainian and EU car-makers could stimulate the development of this branch, in particular by improving its technical equipment and productivity. Free trade between Ukraine and the EU should increase competitive pressure on the market. The new rules of the game will complicate competition with European producers, in particular by introducing component assembly of contemporary car models.

Chemicals

Different ministries have conflicting positions on one and the same issue, which renders policy-making less than effective. Moreover, state aid to one sector, such as agriculture, can harm the growth of a related sector, such as fertilizer makers.

The modernization of companies and the process of adapting to new conditions are taking place too slowly, making it impossible to suddenly cut down on state aid. Domestic producers of lacquers and paints do not directly compete with the EU producers, as they mostly work in the lower price segment of the market, while high-quality products are imported to Ukraine.

State aid as a key FTA component

Including provisions on the state aid and on anti-monopoly policies in bilateral trade agreements has become common policy,¹¹⁹ as the WTO still has no single system¹²⁰ for coordinating these policy issues. An attempt to create such a system was made during the Singapore ministerial conference in 1996. However, differences among member states, especially developing countries, made it impossible to reach an agreement on the majority of Singapore issues during the fifth ministerial conference in Cancun.¹²¹

Normally, the EU requires that its trade partners approximate their policies to EU practice. Existing FTA agreements sometimes include references to GATT rules on state aid and sometimes direct references to the Treaty establishing the EC.¹²² It is common practice to provide for transition periods when it comes to state aid and to introduce specific rules for providing such assistance (for example, if it revives the company receiving it) in specific areas.¹²³ The compliance of such support with the conditions laid down in the FTA agreement is in some cases decided by a Cooperation Council, set up for the purpose by the two sides (see **TABLE 10.2** in **APPENDIX 10**).

EU requirements of Ukraine

State aid is the most unregulated issue in anti-monopoly policy between Ukraine and the EU. Most of the standard EU requirements and conditions regarding the harmonization of state aid legislation are already spelled out in joint agreements between Ukraine and the EU. These include:

- **A LEGAL DEFINITION OF STATE AID** that would match the one adopted by the EU.

¹¹⁹ The related section is present in bilateral agreements between the EU and more than 30 countries. See <http://ec.europa.eu/comm/competition/international/bilateral/extracts.html/#cl> and http://trade.ec.europa.eu/doclib/docs/2005/july/tradoc_111588.pdf.

¹²⁰ Szepi, S., *Comparing EU free trade agreements: Competition policy and state aid*, ECDPM InBrief 6E, Maastricht: ECDPM, 2004.

¹²¹ WTO member countries agreed to discuss only the subject of fostering trade. Other topics, such as anti-monopoly policy, investments and transparency in public procurements, were postponed. It is thought that the EU and Japan, who initiated the agenda in Singapore, understood that consensus would be impossible but nevertheless raised these issues in order that their compromises in this area might avoid deep reforms in the farm sector. See Daniel Ikenson, "Leading the Way: How US Trade Policy can overcome Doha's failings," a *Trade Policy Analysis Paper* by the CATO Institute, 19 January 2006.

¹²² This agreement allows for state aid to be provided on condition that the standard of living is extremely low or unemployment is very high.

¹²³ For instance, five-year transition periods were established for Jordan, Morocco and Tunisia.

- **TRANSPARENCY IN PROVIDING AID.** Fulfilling this demand would require a specific list of institutions that provide state aid, an independent monitoring body, and regular reports about the types, scope and recipients of such assistance.
- **A PRINCIPLE OF PROHIBITING STATE AID IF IT WILL WORSEN TRADE CONDITIONS BETWEEN UKRAINE AND THE EU.**

Ukraine has still to fulfill most of these requirements. While a Bill "On state aid" drafted in 2004 was generally consistent with EU requirements, it had some controversial provisions. Specifically, it provided for the Anti-Monopoly Committee (AMC) to take over the functions of providing and controlling state aid. Today, there are plans to introduce amendments to the Law "On preserving economic competition" to include a definition of state aid. However, according to AMC officials, such issues as the transparency of information on the scope of assistance, the procedures and the criteria for providing assistance remain unresolved. These issues will most probably be shifted into the Agreement on a Free Trade Area between Ukraine and the EU.

Setting up institutions similar to those in the EU for providing state aid is only the first step Ukraine needs to take. The logical end of reform must be to also match the practice of providing assistance. This would not so much entail the reduction of state aid, which happened already in 2005, but a change in its structure. Of course, this is a long-term process, as the experience of newer EU Member States shows. Their state aid structure still differs substantially from that of the EU-15.

At this time, the scope and the structure of state aid in Ukraine and in the EU differ (see **CHART 15**). The total amount of state aid provided in the EU-25 in 2004 was EUR 62bn, or 0.6% of GDP. The amount of support industries in Ukraine got, which took a huge share of total aid, was around UAH 4.3bn in 2002, or 2% of GDP.¹²⁴ On the other hand, the share of horizontal support in the EU was close to 41%, leaving out farming, fisheries and transport, while in Ukraine it was only 3%. Sectoral assistance in the EU amounted to only 24% of total assistance in 2004 and it was shared among the coal (12%), defense (9%) and service industries (3%).

The experience of EU candidate countries

The experience of Central European countries in drafting and enacting anti-monopoly legislation is useful for Ukraine. The EU conditions for providing state aid that these states had to fulfill were almost the same as those Ukraine is dealing with now, as an FTA agreement preceded their accession to the EU for all CE countries.

¹²⁴ Based on CASE – Ukraine calculations, 2004.

A free trade area between Ukraine and the EU will provide both a model and a stimulus for reforming state aid. The presence of such institutions and rules will give the governments of both sides the opportunity to coordinate policies and solve problematic issues in a more effective way. Having formal obligations under the FTA agreement, Ukraine's government will be able to better stand for the interests of the entire country, resisting pressure from traditional branches of industry. In the end, reforming state aid along EU lines should lead to an increase in its effectiveness and productivity.

The FTA+ impact on stakeholders

Harmonizing regulation will have a different impact on different spheres and sectors. Ukraine can and should choose its spheres and levels of integration. For this purpose, the priorities in state aid need to be clearly defined,¹²⁵ and, as far as possible, the positions of stakeholders taken into account.¹²⁶ A number of main stakeholders are likely to be affected by provisions on state aid in the FTA:

- business;
- the regions;
- Government;
- the scientific community;
- consumers.

When the impact of establishing a free trade area with the EU on the economy of Ukraine is evaluated, the overall result is positive. The experience of EU FTAs with other states shows such positive consequences as growing volumes of trade, greater investor confidence, a quicker economic integration in the region, and access to the single EU market for those sectors that are completely in line with EU standards. For consumers, this means access to a larger variety of quality goods and services.

Poorly developed regions will certainly keep getting assistance, in particular in the form of renewed SEZs and TPDs. Regional equalization is an important instrument of state policy in the EU and in most developed countries. Decentralizing state aid policy could become another innovation. In order to increase the impact of assistance, there could be a switch to providing state grants for infrastructure projects, especially in transport.

Reforming state aid will primarily have a negative impact on industry. A large number of strategic sectors in Ukraine are the main beneficiaries of state aid today. The state still needs to complete industrial restructuring, which should result in uncompetitive sectors and businesses either changing owners, or closing down altogether. However, since these sectors have been receiving little state aid and their share in the economy is not as significant as it was at the beginning of 1990s, their further restructuring will not be particularly damaging to the economy. Besides, the state always reserves the possibility of supporting regions with high unemployment and to assist companies put to-

¹²⁵ For instance, while huge reserves of iron ore mean that the steel industry will survive no matter what, whether the space industry can survive without state aid is not so clear.

¹²⁶ The long-term interests of the EU also need to be anticipated. Although the Union is against Ukraine's support of the steel and car-making industries, the expansion of car assembly in Ukraine is inevitable because this business is no longer competitive in Western Europe and western companies are looking to outsource production.

gether clear, transparent restructuring programs. Finally, limits on the amount of assistance can be partly compensated by improving its effectiveness.

Changing the structure of state aid will mean a shift from financial support to specific companies and sectors towards regional and horizontal types of support. For example, among the EU-25, a quarter of total state aid is channeled for environmental purposes and energy conservation, 12% to R&D, and another 12% on SME development.

Although Ukraine and the majority of EU countries are at different levels of economic development, the priorities for horizontal assistance remain relevant for this country. Without scientific development, the economy cannot grow quickly. Solving the issue of energy and at the same time, ecology, is one of the top priorities for Ukraine, which will have to restructure its energy-intensive sectors.

Possible measures under an FTA+

Reforming oversight systems

Measures to be undertaken by Ukraine

Ensuring transparent state aid and informational support for companies in sensitive sectors

Identifying sectors that can become competitive¹²⁷

Investing in human resources through educating and providing opportunities for new careers for workers, in particular in farming

Shifting from preferential schemes and tax breaks to discounted loans and R&D grants¹²⁸

Measures to be undertaken by the EU

Offering Ukraine additional financing for investments to develop priority sectors and expand scientific cooperation

Providing technical assistance to increase government capacity to monitor the effectiveness and results of state aid

¹²⁷ For instance, such hi-tech sectors as the space industry, ICT, and others.

¹²⁸ Including financial resources for SMEs in the form of compensatory interest or venture funding. This has proved the most effective way to stimulate development, as EU innovation funding has shown.

Analysis according to stakeholders

Stakeholder	Pros	Cons
Business	<p>More transparent state aid for reconstruction programs and targeted grants</p> <p>Expanding markets for energy conservation and clean energy technologies</p> <p>Less help to those sectors that traditionally relied on state aid</p> <p>Fewer grounds for trade barriers (anti-dumping probes) by the EU and other countries</p>	<p>Gradual cutbacks to sector benefits, in particular for machine building</p> <p>Growing prices for certain goods and services, in particular energy and transportation</p>
Regions	<p>More freedom for local governments to define purpose and extent of assistance</p> <p>More effective programs for regional equalization (special purpose grants, infrastructure projects)</p>	<p>Possible increase in unemployment</p>
Government	<p>More transparent and more predictable planning and spending of Budget funds</p> <p>A better choice and evaluation of state aid programs</p> <p>More effective coordination of troublesome assistance issues with the EU</p> <p>Quicker restructuring of old sectors of the economy</p>	<p>The costs of the harmonization of legislation and setting up a new state aid system</p> <p>The need to increase support for SMEs, which are the most vulnerable growing competition</p>
The scientific community	<p>More state funding of science and greater demand from businesses</p>	<p>Growing competition in tenders for public funds</p>
Consumers	<p>Less public spending on ineffective support for uncompetitive domestic producers</p> <p>Lower prices on some types of products as cheaper, higher quality imports enter the market</p>	<p>Growing prices on some goods and services, mostly on energy and transportation</p>



Public procurements

The ICPS position is that public procurements should be a component of the Free Trade Agreement between Ukraine and the EU for two main reasons:

- *it will ease bilateral access for Ukrainian and EU companies to both public procurements markets;*
- *legislative and institutional harmonization will make it easier to resolve current problems in Ukraine's public procurements system and establish a framework within which it can function in a civilized manner.*

The negotiating process regarding public procurements should focus on the principles established in the Government Procurement Agreement (GPA). Ukraine will have to establish the necessary domestic system of public procurements based on GPA principles. Since the GPA has specific structural elements and allows developing countries to institute additional limitations for development purposes, Ukraine will have to determine its key positions and decide what additional limitations it might be able to use within the framework of this Agreement.

This section looks at three main aspects of integrating Ukraine's public procurements market to a deep free trade area with the EU:

1. *How compliant the Law "On the purchase of goods, works and services at state cost" is with EU principles and recognized international norms for the functioning of a public procurements market.*
2. *The main components of the FTA+ based on international practice.*
3. *The impact of instituting an FTA+ on various stakeholders.*

Regulating public procurements in Ukraine

The normative basis for the public procurement market in Ukraine is the Law "On the purchase of goods, works and services at state cost." In March 2006, this Law was changed, so that now:

- the functions of the authorized central executive organ responsible for coordinating the procurement of goods, works and services have been transferred from the Ministry of Economy to the Anti-Monopoly Committee;
- the function publisher of the official bulletin on public procurements has been transferred to the Tendering Chamber from the Ministry of Economy;
- official online information about procurements continues to be published by informational systems that meet the requirements of the law;
- the Tendering Chamber was granted special status.

On 1 December 2006, the Verkhovna Rada approved further changes to the direct Law and related legislation. These new changes came into effect as of 10 January 2007, but they had little impact on legal problems that emerged after March 2006.¹²⁹

Some provisions in the Public Procurements Law¹³⁰

With the 17 March 2006 coming into effect of the Law "On amending the Law of Ukraine 'On the purchase of goods, works and services at state cost' and other legislation of Ukraine," the situation actually became more complicated in terms of compliance with EU standards. The main differences between the current version of this Law and EU norms are:

- **A REQUIREMENT TO LIMIT THE NUMBER OF INFORMATIONAL SYSTEMS IN THE INTERNET THAT MAY BE USED** when undertaking public procurements procedures encourages the monopolization of this sphere of activity and complicates the procurement process. Current norms make that information

¹²⁹ From the start of work of his Government, Premier Viktor Yanukovych has talked about reforming the public procurements system. At the Government's request, a Bill was drafted to amend the existing law on procurements. Experts say that this document could indeed have improved the situation in terms of harmonization between Ukrainian legislation in this area and EU and WTO norms. However, hardly any of the Government Bill's more serious, progressive changes have made it into the version of the Bill passed by the Verkhovna Rada. In short, the gaps between the Ukrainian procurement system and international norms and standards remain. Should this sector be included in the FTA+, Ukraine will have to eliminate these differences.

¹³⁰ Materials from Oleksandr Shatkovskiy (Ministry of Economy) have been used to prepare this section.

published about procurements, which is supposed to be freely accessible to potential bidders, dependent on the commercial activity of private entities who can then make it difficult to fully ensure the transparency and accessibility of such information to the Ukrainian public. EU practice and legislation states that preliminary information about procurements (announcements) is published by an official state resource, while detailed information and other communications are published on the sites of the customers, whose addresses must be indicated in the announcement about the procurement.

- **THE NATURE AND ACTIVITIES OF A NEW ENTITY IN THE PROCUREMENTS SYSTEM, THE TENDERING CHAMBER.**¹³¹ Based on its legal status, the Tendering Chamber is a non-profit organization. This does not match international practice and is out of sync with Ukrainian law, as well, especially as regards the organization of state government and the activity of community organizations: by being given such powers, this kind of community organization effectively replaces a government agency.¹³² Moreover, the TCU completely controls the matter of publishing information about public procurements. That is, mandatory publication in the Tendering Chamber Bulletin in order to hold a tender is impossible without placing this information on the internet, and the TCU publishes the list of authorized portals that are allowed to publish procurement information on the internet. Each of these systems can operate according to its own rules, but only the customer is responsible for the timeliness and accuracy of the publication. And thus, the TCU can block any tender procedure at its own discretion. Any ruling by the TCU on public procurements, which customers are obligated to take into account, can be challenged only in the courts.
- **THE ANTI-MONOPOLY COMMITTEE** has been designated the authorized body in procurements according to the amended law, while oversight and control over the public procurement system has been scattered among a slew of government bodies.¹³³ At the same time, the various functions have not

¹³¹ The status of the Tendering Chamber of Ukraine (TCU) is described in law as “a not-for-profit association of community organizations.” This association of CSOs has been given administrative powers that belong to a state administration organ while lacking the necessary level of responsibility and accountability to society for its activities. This makes it possible for the TCU to make fairly arbitrary decisions about the activities of government agencies. For instance, see its 22 May 2006 decision about the non-compliance of SBU letters vis-a-vis current Ukrainian law.

¹³² For instance, the TCU issues rulings on complaints it reviews, which are then used by the Special Oversight Commission for Public Procurements under the Government Accountability Office, which includes among its members representatives of the same TCU, to approve decisions and issue positive rulings on the use of non-competitive procurement procedures.

¹³³ Art. 3 of the current version of the Procurements Law states that state supervision, monitoring and coordination of procurements is done by the Verkhovna Rada, the AMC, the State Oversight Commission, the State Treasury, the Ministry of Agricultural Policy, the State Statistics Committee, and a Special Oversight Commission for Public Procurements under the Accounting Chamber.

been clearly divided and there is no established order for interactions among all the regulatory agents in public procurement. This dissipation of regulatory functions sets up a situation where there is no agreement over supervision, control and coordination, and functions are duplicated among different government bodies.

- **RESTRICTIONS ON COMPETITION IN THE CURRENT LAW** arise because it sets the mandatory requirement of all procurement participants to set aside a large tender and contract security fee and legalizes a monopoly on handling the bids by requiring participants, in the name of the customer, to pay third parties ("consultants") for a variety of services. This kind of situation not only restricts competition but also, in some cases, effectively makes it impossible to run a competitive tender. Many companies refuse to participate in bidding under these kinds of conditions, while those who decide after all to take part simply include their costs in the price of their bid. In the end, the state loses.

The World Bank has assessed the changes made to the Procurement Law as "incompatible with the country's declared aim of harmonizing its legislation with EU Directives"¹³⁴ and as such that will weaken the public procurement system. The changes do not fit with international practice and inflate the ordinary role and competence of the Anti-Monopoly Committee in regulating the public procurement system as the agency responsible for competition policy in the business sector.¹³⁵ Moreover, they attach powers to the Accounting Chamber that are not typical in international practice as an independent auditing organ that oversees the State Budget. Finally, they do not ensure the proper commercial activity of state-owned enterprises, while granting government-like powers to a non-government organization, the Tendering Chamber.

Based on the result of a study of public procurement systems under the SIGMA program,¹³⁶ EU and OECD experts have drawn the same conclusions. Overall, the proposals from MinEcon, the Justice Ministry, the Main Judiciary Administration and the Main Review Administration of the Verkhovna Rada Apparatus, as well as the World Bank have been taken into account in Government Bill №1209 "On amending certain legislation of Ukraine on the purchase of goods, works and services with state funds" dated 5 October 2006.

¹³⁴ See Yuriy Skolotianiy, "Public procurements market in the Twilight Zone after the latest changes to the law come into effect," *Dzerkalo Tyzhnia*, № 12, 1 April 2006.

¹³⁵ According to First Deputy Chair of the AMC Yuriy Kravchenko, as of September 2006, the Committee was still carrying out the functions designated to it in public procurements without the necessary material and human resources.

¹³⁶ "Ukraine: An assessment of the system of governance," March 2006, SIGMA Programme "Support for Improvement in Governance and Management," a joint OECD/EU initiative.

Still, the Bill that was passed by the Verkhovna Rada 1 December 2006, which was a compromise version drafted by a special working group, is anything but progressive. The flaws listed here were not corrected and, for all intents and purposes, not a single significant provision from the Cabinet's Bill made it into the final edition of changes to the Law. What is more, According to the State Department for Adapting Legislation, the number of discrepancies between Ukraine's legislation governing public procurements and relevant EU norms grew 2.5-fold after changes were introduced to the current law in December 2006.

What a Procurements Agreement with the EU might look like

In addition to removing legal discrepancies between Ukrainian legislation and EU and international norms, Ukraine's government needs to thoroughly analyze the structure of the components of a possible FTA+ with the EU.

Should Ukraine sign an FTA+ with the EU, EU countries will not in any way be obligated to change their public procurement systems. Ukraine will have to bring its system into compliance with the principles of the Government Procurement Agreement (GPA).¹³⁷ The level of compatibility will be determined through bilateral negotiations. Still, certain details need to be carefully considered as Ukraine stands to gain additional benefits from the GPA provisions for developing countries. Another key purpose for negotiating would be for Ukrainian products, goods and services to gain access to the EU public procurements market.

The length of the transition period for the optimal adaptation of domestic legislation and institutional structures to EU¹³⁸ and GPA standards **should not be more than 3–5 years**. This is the maximum timeframe that Ukraine needs to orient on during negotiations over a transition period.

These are the main features over which Ukraine needs to establish a clear position in terms of an agreement on public procurements markets (see **TABLE 11**).

¹³⁷ The Government Procurement Agreement is a multilateral WTO document that is the basis for the majority of free trade agreements in the procurements sector. EU Directives that regulate this market are completely compatible with the GPA. However, the GPA includes provisions not only for developed nations, but also for developing countries. A detailed description of the main provisions of the GPA can be found in **APPENDIX 11**. Although the GPA is not mandatory for countries acceding to the WTO, Ukraine has made a commitment to join this multilateral document after acceding to the WTO. At the moment, Georgia and Moldova are in the process of negotiating accession to the GPA.

¹³⁸ The normative base for the EU public procurements sector was established by EC Directives №2004/17/EC and №2004/18/EC.

Table 11. Main structural elements of FTAs in state procurements sector¹³⁹

Structural element	Negotiating options	
Coverage of different levels of procurements	Central Government	
	Subnational government	
	Other organizations, such as utilities ¹⁴⁰	
Principles ¹⁴¹	National basis	
	Most-favorable-nation basis	
	Absence of discrimination	
Transparency	Providing information	In line with national procurements
		Providing full information for application purposes
	Target for disseminating information about contracts	Information about reasons for turning down applications
		National International
Disseminating information about contracts	Providing statistical data about contracts	
Contract-signing procedure	Open bids	
	Limited bids	
	Single bids	
	Selected bids	
Criteria for signing contracts	Lowest price	
	The best application based on criteria	
Technical specifications	Following international standards	
	Utilization features standards a priority over descriptive standards	
	Possible exceptions to standards	
Legal and mandatory measures, appeal options	Options and procedure for appealing decisions	
	Reviewing organ independent and/or supra-national	
	Choice of conflict-resolution mechanism	
	Use of temporary, urgent measures, such as, terminating a contract or procurement or compensating certain expenses, during the appeal process	
Local share of added value, the use of local components	Ban on rules of origin (GPA)	
	Using the same rules of origin as in trade	

Source: ICPS

¹³⁹ The table has been set up on the basis of an analysis of the structure of international FTAs in the area of public procurements.

¹⁴⁰ In addition, at every level thresholds need to be established for products, goods and services. These thresholds are the minimum sum of a contract for public procurement for which the customer organization needs to call a tender.

¹⁴¹ In most agreements, the combination of a national basis and lack of discrimination is applied.

Table 13. Main elements of key regional/bilateral agreements compared to the GPA

	1994 GPA (a)	EU-Chile (b)	EU-Mexico (c)
Coverage		Coverage of central, sub-central government and utilities as per the GPA for the EU and equivalent for Chile	Coverage by Entities broadly equivalent to the NAFTA for Mexico and GPA for the EU
Cat I Central govt	Supplies and works; negative list Services; positive list Thresholds: supplies and services 130k SDR, works 5m SDR	Annexes XI and XII Goods, services and works Thresholds for central govt: 130k SDR for goods, 5m SDR for works Thresholds for subcentral govt: 200k and 5m SDR	(Annex VI) Goods, services and works covered as per schedule (Annexes VII, VIII and IX)
Cat II Subnational govt	"Voluntary" upon first sub-national level No local govt Thresholds: supplies and services 200k SDR and works 5m SDR	Thresholds for utilities: 400k and 5m SDR (i.e. as in GPA 1994)	Thresholds as per GPA 1994 for the EU and NAFTA for Mexico
Cat III Other entities e.g. utilities	Thresholds: supplies and services 400k SDR and works 5m SDR		
Principles	National treatment and MFN for signatories	National treatment and non-discrimination	National treatment and non-discrimination (Art. 26)
Transparency	Information to be provided on national procurement laws and rules Contracts to be advertised to facilitate international competition	Provision of information sufficient to enable effective bids (Art. 142) Statistics on contracts to be provided only when a party does not comply effectively with objectives of the agreement (Art 158) Information of why bids unsuccessful on request (Art. 154)	Provision of detailed information on tenders and decisions Statistics to be provided that help ensure there is no systematic evasion of provisions (Art. 31)
Contract award Procedures	Option of open, restricted or single tendering;	Open and selective (i.e. restrictive). Single tendering possible in exceptional cases (Art 143 –146)	Open, restricted or single tendering; Mexico applies detail as per NAFTA and EU applies detail as per GPA, but the two are essentially equivalent;

>> *continued*

	1994 GPA (a)	EU-Chile (b)	EU-Mexico (c)
Contract award criteria	Lowest price or most economically advantageous bid	Lowest price or most advantageous bid based on previously determined criteria	Lowest price or most advantageous bid based on previously determined criteria
Technical specifications	Use of international standards encouraged; performance standards preferred to design standards	Performance rather than design or descriptive standards (Art 149); international, national or recognised standards to be used, but exceptions possible	No mention
Compliance provisions	Bid challenge introduced in GATT for the first time Independent review Interim remedies, but no contract suspension	Bid challenge (Art 155) Independent review Rapid interim remedies that may include contract suspension, compensation but may be limited to costs of bid and protest	Bid challenge (Art 30) Independent review body with detailed provisions relating to proceedings in the review hearings (as in NAFTA) Rapid interim measures that may include suspension of procurement process but with override in public interest compensation but may be limited to costs of bid and protest
Local content or presence	Prohibits origin rules	None	Substantial business activities test for services possible (Art 27)
Institutional provisions	None	Vague technical co-operation commitment (Art 157)	Special Committee on Government Procurement established to promote mutual understanding of procurement procedures
Extension provisions	None	If a party offers better terms to a third party it must open negotiations on an extension of terms	Bilateral dispute settlement under Title VI of the agreement None

The FTA+ impact on public procurements

The preparation and institution of a Free Trade Area between Ukraine and the EU is a powerful process that will affect the interests of many economic players. The most significant likely consequences of an FTA + for national buyers, national and international players, and for Ukraine's citizens and society are presented in the table here.

Analysis according to stakeholders

Stakeholder		Pros	Cons
National buyers	Government bodies at the national or subnational level	A more convenient and more stable procurement system	
	State enterprises	More effective use of public money as competition grows	
National bidders	Small business	More transparent tenders, less discrimination against participants (those tenders that are covered by the FTA) Easier access to EU tenders	Growing competition between domestic and international participants
	Big business	More transparent tenders, less discrimination against participants Easier access to EU tenders	Growing competition between domestic and international participants
	Ukrainian manufacturers that use semi-legal and prison labor	To preserve the principles currently in operation in the law regarding these categories of manufacturers, there should be minimum or no damage	
EU participants		More effective participation in Ukrainian tenders	
Ukrainian society		Less corruption in the public procurements system Better use of public money as competition grows Lower prices for services from state and community companies	

In addition to these groups, there are certain "hidden" interest groups, meaning individuals or groups who benefit from the flaws in the current public procurement system. ICPS analysts expect such groups to oppose harmonizing Ukraine's system with that of the EU and WTO.



Migration of labor and business

Ukraine's labor has very limited movement as part of the Partnership and Cooperation Agreement with the EU. In fact, this access is narrowed to non-discrimination against Ukrainian nationals who legally work in EU Member States. In the section on free trade outlined in a new, enhanced agreement with the EU that is to replace the PCA, Ukraine has a chance to expand its access to free movement and the related freedom of business activity. However, a significant liberalization of the movement of persons is unlikely.

The FTA+ will establish only general principles that will provide for more favorable conditions for access of Ukrainian nationals to the EU labor market. However, Ukrainian workers and businesspeople will be able to take full advantage only if they themselves are competitive, that is, if they have the necessary education, qualifications, flexibility and mobility and if they offer innovative and quality services for which there is demand within the EU. This means that liberalization must be accompanied by integration in education and social security, liberalization of the visa regime, and the development of new economic sectors and new types of businesses that have the potential to invest in the EU economy and be competitive on its market.

To avoid the negative asymmetric effects of liberalized movement of people and business activity in relations with the EU, the Ukrainian government must continue reforms aimed at improving the business climate in Ukraine, reducing the level of corruption and instituting tax policies that are more favorable to SMEs. Liberalized migration envisaged by the Free Trade Agreement must be accompanied by the adaptation of Ukrainian legislation, norms and standards to those of the EU. This is the main meaning of the "deep free trade" formula that the EU is offering in its new agreement with Ukraine.

Freedom of movement in the EU

The free movement of labor

The free movement of people is one of the four fundamental freedoms of the EU market. The goal of free movement of individuals is to set up a common production and labor market on the entire territory of the European Union that is not limited by the borders of EU Member States. The free movement of individuals would provide individuals with better opportunities to use their qualifications. At the same time, this freedom should contribute to rapid economic growth in specific member states and in the European Union as a whole.¹⁴² **The free movement of people is related to employees, employers and self-employed individuals.** Currently, the free movement of workers is regulated by the 10 norms of the Maastricht Treaty (1992). Six of them are related to European citizenship, which will not be examined as part of this study, while the remaining four norms deal with the free movement of labor (art. 39 – 42).

Currently, the free movement of individuals is the most limited in the European Union. The common labor market is ineffective and inflexible as a result of policies implemented by member states aimed at protecting their own labor markets and supported by numerous trade unions. Other obstacles in the way of enjoying this freedom are the insufficient knowledge of the languages and cultures of the various member states and formal complications, such as the loss of unemployment benefits in the instance of going abroad or drawbacks in the system of pension payments.¹⁴³ The European Commission acknowledged that, without speaking the languages of other member states, EU workers will not be able to use the free movement principle and the opportunities a large labor market should provide. Therefore, the European Commission decided that young Europeans should master three EU languages: their own, a first foreign language to be studied starting in pre-school and a second foreign language to begin being studied in grade school. In addition, it is recommended that some professional subjects in higher educational institutions be taught in the first foreign language.¹⁴⁴

Workers that are nationals of EU Member States that can use this freedom:

- hired personnel;
- future employees, students or individuals participating in professional training;
- former employees (pensioners and unemployable individuals);
- family members of all of the above groups of individuals.

¹⁴² *Prawo wspólnotowe i integracja europejska* by Z. J. Pietras. Wydawnictwo UMCS. Lublin 2005. p. 492.

¹⁴³ *Ibid*, p. 501.

¹⁴⁴ *The White Paper on Education and Training—Teaching and Learning—Towards the Learning Society* by the European Commission. COM(95)590.

The free movement of labor consists of four main rights:

- 1) the right to look for a job and employment;
- 2) the right to move;
- 3) the right to reside;
- 4) the right to remain in the relevant member state after have been employed.

In addition, the free movement of labor connotes the equal treatment of all EU nationals. Any discrimination based on citizenship regarding the access to employment, terms of employment and labor remuneration is prohibited.

The free movement of labor can be limited by member states in a unilateral manner in public order, public safety and public health. The free movement of individuals would also be applied to members of the European Economic Area (Iceland, Lichtenstein and Norway). The right for free movement would be implemented thanks to the systems of coordination schemes for social security and the mutual recognition of qualifications and certificates.

The freedom to engage in business activity

Another aspect of the free movement of labor is **the freedom to do business related to the free movement of employers and their companies**. This freedom is regulated by six norms, laid out by the Maastricht Treaty (Art. 81 – 89).

The freedom to do business differs from the freed movement of labor only by the status of individuals: they are not hired personnel that fulfill someone's instructions and receive remuneration for their work. They are simultaneously employees and employers.

The freedom to do business differs from the freedom to provide services in that service providers on the territory of a different member state function only temporarily, while doing business is a permanent activity. An example of this is the complete liquidation of a company in its home country and the relocation of such a company to a different member state or the receipt of the majority of company profits in a different member state.¹⁴⁵

The right to do business is enjoyed by:

- **individuals** that have gained citizenship in one of the EU Member States;
- **legal entities** set up in one of the EU Member States.

Individuals can enjoy this right, regardless of their place of residence. That is, if they are citizens of one EU Member State, they can make use of this

¹⁴⁵ The above-mentioned work by Z. J. Pietras, p. 513.

freedom both when they reside in the country of citizenship and when they reside in a different EU Member State or even when they reside outside the EU. For example, craftsmen and artisans, artists and individuals of free professions (doctors or lawyers) can do business independently. Such individuals can enjoy this right if they are self-employed.

Legal entities are companies or firms of civil or commercial law, cooperative societies and all sorts of other legal entities of public or private law. The right to do business is not given to non-profit organizations. The condition for enjoying this right is having a legal address or headquarters on EU territory.

The right to engage in business activity consists of the right:

- to access self-employment;
- to set up a company;
- to do business.

There is also the principle of national treatment that excludes discrimination or restrictions on doing business. For example, direct discrimination has prohibited a ban on purchasing real estate for individuals who are not nationals of a particular EU Member State. Indirect discrimination has also banned the requirement for foreigners to know the language of the country where they seek for a job.¹⁴⁶

Only private individuals have the right to engage in independent business activity on the basis of self-employment. Instead, both private individuals and legal entities can set up companies, as well as agencies, departments and branches. They also have the right to financially participate in the capital of companies operating in the relevant member state, as well as the right to employ nationals of the relevant member state. According to the Council Directive 75/34/EEC, self-employed individuals can remain on the territory of relevant member state along with their families if they have reached 65 years of age, are unemployable or have begun to work on the territory of another member state, but continue to reside in the member state in which they previously did business. **Exceptions to this freedom are only:**

- participation in government (this principle applies not to holding an office per se, but activities);
- public order;
- public safety;
- public health.

¹⁴⁶ Ibid, p. 515.

Expanding free migration to third countries

The free movement of labor in FTAs with third countries: A comparative analysis¹⁴⁷

The free movement of persons, which is specified in the EU-25 (with temporary restrictions on the new EU Member States) and on the EEA, **is restricted for third countries, depending on the individual agreements with each specific country.** The principles underlying the liberalization of the movement of individuals and doing business between the EU and third countries are written into a series of individual agreements.

As a rule, these are basic agreements that have different names and contents, depending on the level of the EU's relations with the country in question. Turkey agreed on these issues with the European Communities in the Association Agreement in 1977 in the section on setting up a free trade area. For accession countries of the last wave of enlargement, these issues were regulated by trade-related parts of the European Union Association Agreements signed in the early 1990s. For Western Balkan countries, these issues were regulated by the Stabilization and Association Agreements concluded in the first half of this decade.

The CIS countries' relations with the EU regarding the movement of labor and the establishment of companies are regulated by the Partnership and Cooperation Agreements. For countries of the Barcelona process, these issues are regulated by the Association Agreements in sections that deal with the movement of services and social cooperation. For non-European countries such as Mexico or Chile, these provisions are written into trade-related sections of the Association Agreements.

Both economic and political factors influence the degree of the liberalization of the movement of labor and doing business written into the agreements between the EU and third countries. Economic factors are primarily the level of economic development in EU partner countries, the level of the development of trade and economic relations between the EU and the specific partner and the degree of integration of the partner country's economy into the EU Internal Market. However, the level of political relations in the relevant agreement has no less impact on the opening of the EU's labor market for nationals of third countries. The EU included the most liberal provisions

¹⁴⁷ For norms that regulate the movement of labor and the establishment and operation of companies in various types of agreements between the EU and third countries, see [APPENDIX 12](#).

on access to the Internal Market for employees and companies of third countries in the Association Agreements with CE countries that shared a common political goal of future membership in the European Union.

After all, the free movement of labor is not only an indispensable condition for the integration of a third country into the EU Internal Market. It also fosters the rapprochement of EU nationals with nationals of the third country in question as a future member and the implementation of the concept of European citizens in practice. This is why the agreements with future EU Member States expand the rights of workers to their family members who, in the instance of legal residence on EU territory, receive access to the labor market. Identical provisions are present in the agreements between the EU and the Balkan countries.

All types of agreements contain standard provisions that regulate the movement of labor. First, **this is the principle of applying national benefits to nationals of third countries that legally work in EU Member States.** This principle means that nationality-based discrimination is unacceptable in terms of the conditions of labor and remuneration or dismissal/retirement compared to that of EU citizens.

Secondly, **access to social security.** For legal workers from third countries and their family members (in the PCAs—only for workers), the agreements also provide for the right to accumulate all time periods of insurance, employment and residence in different EU Member States that constitute the basis for accruing pensions and other payments. Pensions and other social payments will be freely paid on the entire EU territory, regardless of which member state accrues them. The main difference between the PCAs from the rest of agreements is that they do not provide for the payments of any EU member state to support the family of a worker from a third country, something specified in other agreements.

The Association Agreement with Poland envisages that the European Union will provide technical assistance to set up a relevant social security system in Poland. If bilateral agreements between a country outside the EU and an EU Member State establish a more favorable regime for citizens to access the markets, they must be applied instead of those provisions written noted in the relevant agreement with the EU.

The norms regulating business are usually specified in a separate section on the establishment of companies. As for nationals (individuals), “establishment” means the right of individuals to initiate and engage in business on the basis of self-employment and the right to set up and manage companies, especially the companies they control. Activities based on self-employment and business done by such individuals does not give them the right to access the market of hired labor of the other party.

For companies, “establishment” means the right of a company from the EU or a third country, in this instance—Ukraine, to initiate business through the establishment of subsidiaries and branches in Ukraine or in the EU. Business means industrial, commercial, professional and handicraft economic activity.

An “EU company” or a “Ukrainian company” means a company registered according to the legislation of a member state, or Ukraine, that has a registered office or central administration, or the principal place of business on the territory of the EU or Ukraine.

The difference between the Partnership and Cooperation Agreement with Ukraine and the Association Agreements and the Stabilization and Association Agreements that contain sections on free trade is that the freedom of initiating and implementing business applies only to legal entities in the PCA. Meanwhile, in agreements with accession candidates, private individuals who are nationals of the relevant country can also do business. The restrictions are instituted only for the duration of transition periods.

In addition, these agreements provide for a different treatment to facilitate the establishment and operation of companies, subsidiaries and branches. The Association Agreements and the Stabilization and Association Agreements provide for special treatment.

All types of agreements provide for the right of companies from a third country and the EU and their subsidiaries and branches to hire employees and officials that are nationals of the third country in question or the EU Member States, provided such employees constitute key personnel (see [APPENDIX 12](#)). Permits for residence and employment are issued to such employees only for the duration of such employment.

The Association Agreements and the Stabilization and Association Agreements provide for the right of subsidiaries and branches to lease and purchase real estate needed to carry out business activity in the receiving country, enjoying the same rights as national companies. Usually, an exception from this rule is the right to purchase natural resources, farming land, forests and woods for ownership. Transition periods can be related to doing business in certain economic sectors. As a rule, such restrictions are instituted on the financial services markets. Thus, in Poland, the EU banks could operate only as subjects of Polish law during the transition period and obtained the right to open branches only after the transition period.

Usually, specific norms regulate the provision of air, river and sea transport services.

The movement of labor and business in the PCA: What an FTA+ can offer

The movement of individuals between Ukraine and the EU is regulated as part of the European Neighborhood Policy (ENP). Noting the development of the ENP in its Wider Europe communication,¹⁴⁸ the European Commission declared the expansion of all four freedoms to the EU's neighbors as the final goal of cooperation:

“Russia, the countries of the Western NIS and the Southern Mediterranean should be offered the prospect of a stake in the EU's Internal Market and further integration and liberalization to promote the free movement of persons, goods, services and capital (the four freedoms).”

However, in the strategic document of the ENP, issued one month later, this goal was narrowed to the prospect of facilitating the visa regime and supporting traditional contacts between residents of border regions. In the last communication of the European Commission regarding the strengthening of the ENP, key elements of the ENP are the institution of deep free trade and the facilitation of mobility. Although these proposals do not directly mention the movement of labor, in the future, the institution of deep free trade in goods and services and the approximation of national legislation will open greater opportunities for Ukrainian workers and companies seeking to enter European markets.

The PCA between Ukraine and the EU contains two sections that regulate the conditions of work and the conditions that influence the establishment and operation of companies. **The principle of non-discrimination on the basis of citizenship is applied only to Ukrainian citizens that legally work in EU Member States.** Unlike the agreements with accession candidates, **the right to access the labor market does not apply to family members of workers who legally reside on EU territory. Provisions related to social security are related only to such workers.** Expanding access to the labor market for family members of a worker is one of the objectives for the next agreement between Ukraine and the EU.

Covering the general principle of non-discrimination, the PCA emphasizes that the details of access to labor markets and the protection of the rights of foreign workers are regulated by the national legislation of EU Member States. Regardless, the European Court made several decisions that conflicted with Ukrainian legislation and protect the rights of foreign workers in the EU against nationality-based discrimination. This trend (in transferring a greater part of power to European institutions and in harmonizing legislation) could mean the more effective regulation of this problem for Ukraine, provided the new agreement contains clearer formulations of the relevant provisions.

¹⁴⁸ *Wider Europe—A Neighborhood: A New Framework for Relations with our Eastern and Southern Neighbours.* A communication from the Commission to the Council and the European Parliament. Brussels. 11.03.2003. http://ec.europa.eu/world/enp/pdf/com03_104_en.pdf.

Regarding the establishment and operation of companies and their branches, Ukrainian companies are guaranteed no less favorable treatment than that given to companies from third countries. Subsidiaries are guaranteed special treatment. This process is complicated because of a series of restrictions and reservations listed in Annex IV to the PCA. These include reservations of EU Member States in the participation of foreign companies in mining, fishing, agriculture, the purchase of real estate, the provision of audiovisual services (including radio and telecommunications services), professional services, reserved services for private individuals that are EU nationals, etc. In addition, the national legislation of EU Member States is having a significant impact on the adjustment of the conditions for the establishment of companies by foreign citizens. However, **the main obstacles** to the more active development of business relations between Ukrainian and European businesspeople and companies are **the overall unfavorable investment environment in Ukraine**, burdensome administrative procedures and corruption, as well as the **low competitiveness of Ukrainian companies on the European market**.

Therefore, the main objectives of the Ukraine–EU Action Plan regarding the establishment and operation of companies is to create a conducive environment (the adoption and enforcement of national legislation on competition and bankruptcy) that would eliminate the possibility of there being a favored nation and discrimination and preserve the conditions under which investment has already been made, eliminate restrictions on the establishment of companies and support the effective operation of the central coordination body, which will help simplify the procedure for setting up companies. Ukraine must also improve the competence and independence of auditors, adjust and ensure the effective institution of the key principles in the relevant international and European rules and standards for regulating business activities, set up a state register of legal entities and sole proprietors, ensure publication of information about the organization and financial standing of companies and foster the adoption of a corporate governance code.

In the PCA, the right to set up companies and to engage in business activity is given only to legal entities. The main potential of the new agreement is to expand this right to private individuals and also to ensure special treatment for Ukrainian companies. With Ukraine's accession to the WTO, service providers from Ukraine will be able to obtain temporary access to the EU markets according the Mode 4 for service provision of the General Agreement on Trade in Services (GATS), which provides for the temporary presence of private individuals on EU territory.

Evidently, as part of the Free Trade Agreement, **Ukraine will be interested in instituting certain restrictions or transition periods for some types of business activity.** The most widespread example among the accession candidates was the restriction on the right of foreign companies to purchase farming land.

In Ukraine, even residents do not enjoy this right. In addition, restrictions are usually imposed on the provision of services in the financial sector—banking and insurance services. However, with Ukraine's accession to the WTO, this area will be largely liberalized.

In addition, Ukraine can make use of the right to introduce restrictions on the business activity of European companies in industrial sectors that are being restructured or are going through a crisis with serious social consequences for Ukraine, where there is a threat of a significant decline in the market share of Ukrainian enterprises or in newly created sectors.

The main achievement of the new agreement compared to the PCA should be the obligation to expand the interpretation of its norms, which is the main difference between the PCA and the Association Agreements in terms of the law.

The impact of the EU policy on labor migration

EU visa policy towards Ukraine

Free movement is significantly restricted by the visa regime for Ukrainian nationals when crossing the external borders of the EU. A decision to cancel the visa regime would be made by the Council of the European Union upon the suggestion of the European Commission and with due consideration by the European Parliament. This issue is not regulated by international agreements and does not depend on the status of a third country with the EU. Thus, for example, Macedonia, Turkey and Croatia have begun negotiations on their accession to the EU, but Croatian nationals do not need visas to enter the EU, while Macedonian and Turkish nationals do.

Along with Ukraine, the list of countries whose citizens must be in possession of a visa to travel to the EU includes the CIS countries, Mongolia, Western Balkan countries (except for Croatia) and the Mediterranean countries (participants in the Barcelona process, except for Israel).¹⁴⁹

After Ukraine permanently cancelled visas for nationals of the EU and countries of the European Economic Area in 2005, an asymmetric visa regime has remained in effect between Ukraine and the EU. Undoubtedly, this is better for Ukraine than the previous regime, as it fosters tourism, business connections and personal contacts as a whole. This is also a clear strategic and positive signal in terms of Ukraine's international reputation.¹⁵⁰

The EU links the question of opening borders for nationals of third countries with the questions of border security and the counteraction of illegal migration. Therefore, the prospect of canceling visas for short-term stays of Ukrainian nationals in the EU will be influenced by the implementation of the Readmission Treaty between Ukraine and the EU and the capacity of Ukraine to protect EU borders from illegal migration. At the level of official representatives of the EU, statements have already been made that further liberalization of the visa regime with Ukraine will be discussed after the evaluation of the first consequences of implementing the Agreement on the Facilitation of Issuance of Visas and the Readmission Treaty between Ukraine and the EU.

¹⁴⁹ Council Regulation (EC) №539/2001 of 15 March 2001, listing the third countries whose nationals must be in possession of visas when crossing the external borders and those whose nationals are exempt from that requirement.

¹⁵⁰ *The Prospect of Deep Free Trade between the European Union and Ukraine* by Michael Emerson, T. Huw Edwards and others. CEPS. Brussels. 2005. p. 107.

After the Agreement on the Facilitation of the Issuance of Visas, signed by Ukraine and the EU in October 2006, **comes into force, a rather broad base of Ukrainian nationals will have simplified access to Schengen visas**, thanks to a simplified application procedure, including that for multi-entry visas, and exemption from visa fees.

The Agreement on the Facilitation of the Issuance of Visas regarding all Ukrainian nationals **provides for a unified visa procedure in all consular institutions of EU Member States and for keeping the consular fee at EUR 35**. In addition, free five-year, multi-entry visas can be issued to Ukrainian officials of central and local government bodies, permanent members of official delegations, journalists and parents or children of Ukrainian nationals who reside on the territory of the European Union on legal grounds, as well as businesspeople, but for a fee. The category of individuals that will be issued one-year, multiple-entry visas includes scientists, cultural workers, sportsmen, members of rail crews and professional carriers. The recognition of the institution of a visa-free regime for Ukrainian nationals as a long-term goal would be considered a political achievement.

This agreement will replace all bilateral agreements on the visa regime with EU Member States, that is, all agreements signed with Central European countries. According to these agreements, Ukraine currently has a preferential visa regime and free visas. In practice, this means the institution of stricter conditions for entering these countries. The impact of instituting this agreement should be alleviated by way of additional bilateral agreements on the visa-free entry of residents of border regions for a definite period of time that Ukraine is expected to sign with Poland, Slovakia and Hungary.

Even on the condition of simplifying the visa regime for enlivening the movement of labor, Ukraine and the EU must resolve a number of problems related to the recognition of professional qualifications, employment of "key personnel" as part of the free business activity and the coordination of social security systems. The program for fostering the movement of persons between Ukraine and the EU could also contain certain goals of current border cooperation programs, such as reducing administrative and institutional barriers and supporting the development of international business activity.

EU immigration policy

The policy for regulating the national labor market is part of the competence of EU Member State governments. Among the European Union Member States, there are different approaches to and legal norms for regulating the employment of nationals from third countries. The general approach is for a member state to require that the relevant employer should present evidence that the supply on the domestic market does not meet the requirements of the vacancy.

Nationals of third countries who seek employment on the territory of the European Union are required to present a work permit, which is issued only at the discretion of the member state in question and the main condition influencing the decision is a thorough evaluation of the country's domestic labor market. Some countries use the principle that implies that a national of a third country has the right to a particular job only if an EU national cannot be found that fulfills the job description.

One of the main conditions for obtaining a work permit is legal residence in one of the EU Member States or the acquisition of a residence permit. Exceptions to this rule related to a mandatory work permit can be certain groups of individuals (employees of diplomatic representative offices, members of international organizations, journalists, etc.). In addition, all member states have special norms that make it possible to react to the needs of the domestic market and to support the country's economy with the labor it is lacking. For this purpose, **member states institute a simplified procedure for obtaining a work permit for representatives of specific professions.**

EU Member States instituted special norms that regulate access to the labor market for seasonal workers engaged in tourism and agriculture. These norms provide for the provision of a work permit for a season without the right to prolongation. In certain countries, there is a system of quotas that makes it possible to regulate access to domestic markets through the issuance of annual decrees or relevant orders. Overall, simplified access to the labor market can be provided for specialists that are in short supply on the market and nationals of certain countries on the basis of bilateral agreements.

Thus far, it seems that improving access to the EU labor markets for Ukrainian nationals can only be done through bilateral agreements. Currently, Ukraine has bilateral agreements on employment with six EU Member States: Latvia, Lithuania, Poland, Portugal, Slovakia and the Czech Republic. Specifically, these agreements regulate the conditions for Ukrainian nationals to access the labor markets of these countries. The majority of these agreements were signed in the mid-1990s. However, their contents did not change after the accession of Central European countries to the EU.

The European Union is currently discussing developing a common approach to managing labor migration. In November 2005, the European Commission published the relevant Green Paper where it acknowledged that immigration flows can meet the requirements of the European labor market and ensure Europe's prosperity and also noted that immigration fosters business activity. Secondly, although the European Commission fully recognizes the right of member states to regulate access for nationals of third countries to their labor markets, it specifies that a policy implemented by one member state always affects the interests of another member state in this area (the expansion of the right to free travel within Schengen state borders, the right to provide ser-

vices, the right for those who permanently reside in one EU Member State to move to another EU Member State and the impact of the decision to accept a labor migrant considering the situation on the EU labor market).

Therefore, according to the European Commission, transparent and more harmonized rules and criteria for accepting economic migrants is important. The European Commission proposes to apply a horizontal approach (developing unified conditions for the entry and stay of nationals of third countries for the purpose of employment for a period exceeding three months) or sectoral legislative proposals (seasonal workers, internal corporate assignees, workers with special qualification and contract workers). The European Commission is also proposing the introduction of a unified procedure for the quick admission of migrants in the instance of a shortage on the labor market.

So far, these are just proposals at the level of the European Commission that need to be discussed by member states and, ultimately, need a decision from the Council of the European Union. However, these proposals reflect the need for the development of the European policy regarding economic migration and a trend in the gradual transfer of immigration policy as a whole to the EU level.

The impact of liberalizing the EU labor market

Pros

- **POLITICAL:** The democratization of Ukraine, support for a policy towards European integration. Ukrainian tourists, students and workers will have an opportunity to see how democratic standards and free market economy function within the EU and what the living standards for the population there are like. Upon returning home, they will support the institution of these standards in Ukraine's political and social sectors.
- **HUMANITARIAN:** The enlivening of interpersonal contacts between Ukrainians and EU nationals, which will foster the ruination of numerous stereotypes both in Ukraine and the EU, mental and cultural rapprochement of nationals of Ukraine and the EU, integration of the Ukrainian cultural space into the All-European space, growing knowledge of Ukraine in Europe and that of Europe in Ukraine.
- **ECONOMIC:** The most evident impact will be improved social standards of labor as a result of approximating EU and Ukrainian legislation.
- **THE ATTRACTION OF ADDITIONAL LABOR RESOURCES AND ENLIVENING OF BUSINESS ACTIVITY.** For the countries of origin of migrants, which will be Ukraine in the instance of mutual liberalization of the labor market between Ukraine and the EU, migration brings additional profits in the form of migrants' money transfers home. According to the World Bank, money transfers can foster economic growth in the country as a whole, if they are spent on financing education, healthcare and capital investment. They also foster an increase in per capita incomes, reducing poverty and income inequality. A study carried out in the Ternopil oblast in 2001 shows that labor migrants from Ternopil transfer approximately US \$100mn per annum or, on the average, US \$4,000 – 6,000 per capita per annum. This amount is many times higher than the volume of foreign investment in the Ternopil oblast.¹⁵¹

For Ukraine, a special challenge is to create a favorable investment climate so that earned capital and new skills and abilities of migrants provide incentives for Ukrainian nationals to return to Ukraine and to start their own business and create new jobs, thus fostering long-term economic growth.

¹⁵¹ *The State of Observing and Protecting the Rights of Ukrainian Nationals Abroad.* A special report by the Verkhovna Rada Commissioner for Human Rights. Kyiv. 2003. p. 31.

- **THE GROWING EDUCATIONAL POTENTIAL OF UKRAINE.** Ukrainians gaining an education that meets European standards and professional experience (including the knowledge of foreign languages) and the improved quality of education as a result of harmonizing Ukrainian standards and norms with those of Europe.

According to the Ministry of Education, 37,000 Ukrainian students are currently studying abroad. The approximation of standards in education, the implementation of provisions of the Bologna Declaration, facilitated access to information about the opportunities for education and the simplified visa regime for students and scientists will foster an increase in these numbers.

Ukrainian specialists are proposing the transformation of the brain drain into the "exports of specialists," which will make it possible to maximally and effectively use Ukraine's scientific potential to support its education system. An attractive and special feature of "exporting specialists" is the creation of a "scientific diaspora": a peculiar organization of emigrants from Ukraine that work abroad who would help Ukrainian students and post-graduate students that move to study abroad and would also provide consulting support to Ukrainian scientific and government institutions.¹⁵²

- **THE ENLIVENING OF TOURISM BETWEEN UKRAINE AND EU MEMBER STATES.** After Ukraine cancelled visas for foreigners, the number of incoming tourists in Ukraine significantly grew. Immediately after the institution of a visa-free regime for nationals of the EU and Switzerland, the number of tourists from these countries grew 130% in May – June 2005 compared to that of the same period the previous year. However, the potential of this sector has yet to be exhausted.

Cons

- **THE SHRINKING POPULATION.** In the next 70 years, the country's population will shrink more than 20%.¹⁵³ This is related to the country's low birth rate and the high death rate that are affected by the economic situation in Ukraine. As time goes by, the rate of mortality in Ukraine will decline, but due to the aging population and low fertility rates, the overall mortality will outpace the overall birth rate, resulting in the shrinking of the population. If emigration accelerates, the country's population will shrink at a more rapid pace. A decline in the number of employable persons in the population is also

¹⁵² *Ukraine's European Integration: The Role of Science and Education. General Analysis and a Number of Specific Proposals* by A. Boyarskiy, V. Chernov and O. Ruchaiskiy. Citation according to The Center for Peace, Conversion and Foreign Policy of Ukraine. *The Migration of Highly Skilled Specialists from Ukraine: the Current Situation and Challenges for the Future*. Analytical report №3/2006

¹⁵³ Pension Reform // *policy studies*. ICPS. October 2000. №12, p. 9–11.

increasing the burden on the pension system, while a shortage on the labor market is creating the need to attract migrants from abroad.

According to the Ministry of Labor and Social Policy, 2.5 – 3mn Ukrainian nationals work abroad. It is impossible to make accurate calculations and, thus, various officials and agencies frequently voice even higher figures. There are also no sociological data regarding what part of Ukrainian labor migrants returns to Ukraine or plans to return to Ukraine. The threat is that labor migrants who decide to stay abroad drag entire families along and Ukraine is losing members of the next generation. Even if adult migrants do not take their children along, the regions with a high level of emigration are experiencing a phenomenon called “social orphanhood,” when children have living parents, but are deprived of their care and support and have problems with socialization.

- **THE LOSS OF LABOR RESOURCES, THE BRAIN DRAIN AND A POSSIBLE SHORTAGE OF SPECIALISTS IN SOME ECONOMIC SECTORS.** In countries for which labor markets of EU member states are partly open, there is a shortage of specialists in certain sectors. Thus, Poland currently has a lack of teachers, medical personnel and specialists with secondary technical educations. There is also a shortage of professionals in construction and agriculture.

The same trends can be observed in Ukraine. On one hand, a shortage of labor resources in low-paid sectors is growing: teachers and doctors in rural areas. On the other, the gap between supply and demand on the labor market is growing because qualifications of potential employees are not meeting the requirements of employers. Thus, according to the Ministry of Labor and Social Policy, there were 1.5mn vacancies in 2006. At the same time, the number of unemployed individuals was 1.5mn Ukrainians in January – November 2006.

Despite the lack of precise data, relative data demonstrate that the intensity of the emigration of highly skilled specialists from Ukraine is not extremely high compared to the majority of Eastern European countries. The level of education among Ukrainian labor migrants (10.9 years of education) is, albeit slightly, lower than the level of the education of the population employed on the territory of residence (for Ukraine, this indicator constitutes 11.4 years).¹⁵⁴ Ukrainian labor migration in the 1990s – early

¹⁵⁴ External labor migrants from Ukraine can boost the high level of education in the UK (12.5 years of education), the US, Canada (12.3), Austria, Belgium, the Netherlands, Germany, Luxembourg and France (11.8). The higher than average level of education across the entire mass of external labor migrants revealed Ukrainians working in Israel (11.5), Spain, Greece and Portugal (11). The level of education was below 10.7 years among Ukrainian labor migrants working in the Russian Federation, the Czech Republic, Poland, Hungary and Slovakia. See *Modern Ukrainian Labor Migration: Status and Opportunities* by O. Khomra // Verkhovna Rada hearings called “The State and Problems of Legal and Social Status of Modern Ukrainian Labor Migration.” Information and reference materials. Kyiv. 2004. p. 15.

2000s was primarily migration of blue-collar workers and entry-level specialists and scientists. Although, again, there is a lack of authentic data, it is possible to assume that only an insignificant part of Ukrainian specialists continued to work abroad according to their profession due to the lack of competitiveness or the lack of the recognition of qualifications and certificates (the exceptions are only specific professions—chemists, physicists, etc.), while representatives of many other professions turned out to be uncompetitive on the labor markets of foreign countries.¹⁵⁵

¹⁵⁵ *The Migration of Highly Skilled Specialists from Ukraine: The Current Situation and Challenges for the Future*. Analytical report №3/2006. The Center for Peace, Conversion and Foreign Policy of Ukraine.

Related areas: education and social security

Mutual recognition of qualifications and certificates

The mutual recognition of qualifications and certificates is an important component that ensures the structure and operation of the common labor market in the European Union. Inside the EU, mutual recognition of qualifications and certificates secures the free movement of individuals, the freedom to provide services and the freedom to establish companies, all guaranteed by the Maastricht Treaty. In terms of purpose, recognition of qualifications and certificates is divided into two types: recognition for academic purposes and professional recognition.

Academic recognition of qualifications and certificates is carried out for training and education. As each EU Member State independently decides how to organize its system of education and establish requirements to the quality of educational programs, qualifications and certificates are not recognized at the EU level. Qualifications and certificates are recognized at the level of universities. To simplify this procedure, the Bologna Process was initiated to unify education systems. There are also certain programs for recognizing qualifications and certificates (specifically, Erasmus). However, participation in such programs is purely voluntary.

Although Ukraine is a participant in the Bologna Process and a party to the 1997 Lisbon Convention on the Recognition of Qualifications Concerning Higher Education in the European Region, this does not mean that qualifications and certificates given by Ukrainian higher educational institutions are automatically recognized abroad. EU educational institutions set their own requirements to foreign qualifications and certificates and it is necessary to prove the compliance with these requirements in each specific instance.

Professional recognition of qualifications and certificates in the EU is carried out for further professional activity related to the obtained qualifications and certificates. Mostly, there are no unified requirements for the professional recognition of qualifications and certificates at the EU level: Employers in each particular country decide on recognizing qualifications and certificates at their will. The recognition of such qualifications and certificates is regulated by the labor market itself in each member state. This complies with the principles of the free movement of individuals, the free provision of services and the free establishment of companies. However, there are exceptions from this rule that are related to certain professions that require a special procedure for recognizing qualifications and certificates. Otherwise, the relevant individuals will not have the right to engage in professional activities in another

country that is part of the EU. There are also professions where the recognition of qualifications and certificates takes place automatically, for example, pharmacists, doctors, veterinaries, architects and nurses.

Ukraine's participation in the Bologna Process

Ukraine joined the Bologna Process in 2005, committing to introduce the relevant changes to the national system of education and to join the work to identify priorities in the process of setting up a common European Higher Education Area by 2010. Currently, the institution of the Bologna system in Ukrainian higher educational institutions is at the initial stage. Ukraine is going through the intensive reorganization of the structure of its universities and implementing administrative reforms and certain reforms in the education system. The majority of higher educational institutions have already introduced a modular and rating system. Starting in 2007, a new list of professions and qualifications adjusted to meet European requirements will be introduced in Ukraine. This will foster the exchange of students and will open opportunities for Ukrainians to continue to study in EU Member States.

However, there is a number of problems on the way to introducing the Bologna system in Ukraine:¹⁵⁶

- The lack of a formulated legislative base;
- The growing breakup of connections between education and the labor market;
- The two-stage system has not been instituted in full. There is confusion in understanding the level of specialists and masters. The system of academic degrees is more complicated compared to the general European system, which complicates the problem of the mobility of teachers and academicians in Europe;
- Ukraine has problems with the operation of the system for advanced professional development and retraining. A new system that would satisfy the needs of a market economy has not been created. Therefore, the very important general European principle of a "life-long education" cannot be implemented in our country in full.

The main factors that have a negative impact on the mobility of Ukrainian students are:¹⁵⁷

- The low level of financial support for the development of student mobility;
- The weak support for a simplified visa regime for students;
- A low level of informational support for students regarding the opportunities and terms of studying in the higher educational institutions of Europe;
- A low level of support in the Ministry of Education and Science for the mobility of students through the provision of grants; and
- Limited access for Ukrainian nationals to grants offered in EU Member States.

¹⁵⁶ *The Bologna Process is a Structural Reform of Higher Education in the European Union* by M. Z. Zhurovskiy, Rector of the National Technical University Kyiv Polytechnic Institute (NTUU KPI), <http://ntu-kpi.kiev.ua/education/charta.html>.

¹⁵⁷ A report of Deputy Minister of Education and Science Mykhailo Stepko.

Professions to which there are special requirements written into the EU Directives on the recognition of qualifications and certificates require certain procedures in the relevant EU Member State where an individual has decided to engage in the relevant activity. Such procedures can be an internship in a certain profession in the country of stay within a definite period of time and qualification exams (for lawyers). However, there is no automated recognition of qualifications regarding such professions. In each specific instance, specially authorized bodies of the relevant country determine whether to admit such an individual to the relevant professional activity. Recognition of qualifications means that the individual has the right to engage in the professional activity under the same conditions as nationals of the receiving country. However, this does not mean that the certificate of such an individual is equivalent to national certificates of the relevant country.

There are no agreements between Ukraine and the EU that would regulate the engagement in professional activity in sectors where the EU has a special procedure for the recognition of qualifications and certificates. This is why Ukrainian nationals do not have the right to practice these professions in EU Member States. As for the rest of professions where the engagement is not regulated at the EU level, qualifications and certificates attained at Ukrainian educational institutions are recognized according to regulatory documents of member states and do so in line with the desires of employers. The EU does not have any measures to facilitate such recognition.

Mutual recognition of documents on education, academic degrees and academic ranks is also carried out on the basis of bilateral inter-governmental agreements. Although Ukraine has signed such agreements with 24 countries, there are only six European countries among them: Bulgaria, Poland, Romania, Slovakia, Hungary and France (only regarding the recognition of various academic degrees and ranks).

Coordinating social security systems

Social security systems are coordinated between Ukraine and third countries on the basis of inter-state or inter-governmental agreements. Ukraine is party to two inter-state agreements on social security and 17 inter-governmental agreements on cooperation in pension security and on labor activity and social protection of nationals working outside of their countries. Among the EU Member States, Ukraine has valid agreements with Estonia, Spain, Latvia, Lithuania, Slovakia and the Czech Republic.

For full implementation of provisions of the Partnership and Cooperation Agreement with the EU that are related to the coordination of pension security, Ukraine must continue the process of concluding agreements with member states on the full implementation of these provisions. The Ukraine – EU

Action Plan for 2006 provides for expert negotiations with Germany, Portugal and Hungary regarding the agreements on pension security.

Ukrainian legislation provides for the right for the support within universal mandatory state social pension insurance for insured Ukrainian nationals, foreign citizens and stateless individuals and their family members that reside in Ukraine. Foreign citizens and stateless individuals that reside in Ukraine have the right to pensions on equal footing with Ukrainian nationals on conditions specified in the national legislation or inter-state agreements.

The only type of pensions that are transferred to Ukrainian nationals that emigrated to a permanent place of residence abroad are disability pension assigned in Ukraine as a result of a labor injury or a disease associated with work. Other types of pensions are paid if it is envisaged by an international agreement of Ukraine that was approved as mandatory by the Verkhovna Rada.

The procedure for transferring pensions to Ukrainians who moved abroad and paying pensions to nationals of foreign countries residing in Ukraine are determined by the 6 April 1993 Cabinet of Ministers Resolution №258 "On the procedure for transferring pensions to individuals who moved abroad for permanent residence to other countries" and the 23 April 1999 Resolution of the Pension Fund Board №4 – 5 "On approving the Instruction on the procedure for transferring pensions to individuals who moved abroad and paying pensions to pensioners of foreign countries who reside in Ukraine."

In practice, pensions given to individuals who reside in EU Member States are, in fact, not transferred. This is restricted by the resources of the country's budget. In addition, Ukrainian nationals that work in EU Member States frequently do not want to receive pensions from Ukraine, as this does not make it possible for them to obtain social security in the amount that is provided in the EU Member States. For Ukraine to be able to pay pensions abroad, there should be a system of social insurance. In addition, Ukraine does not have the mechanisms for tracking the incomes of its individuals who move abroad and the mechanisms for tracking Ukrainian nationals working abroad. According to licensed intermediary companies, 58,000 individuals were employed abroad in 2005, meaning this figure constitutes only 1 – 2% of the real numbers of labor migrants.



Environmental policy

There is growing awareness in the European Union that the model of economic development formed in the second half of the 20th century is no longer suitable to the realities and challenges of today's world and that it's time to switch to a new model of sustainable development. This is now determining the direction of changes at the policy and legislation levels in both the EU as a whole and in its Member States.

An agreement on free trade (FTA) between Ukraine and the EU could offer the complete removal of cross-border tariffs on goods and some liberalization in the service sector. The EU has established the practice of including chapters on the environment in its agreements with third countries, especially in FTAs. This approach will undoubtedly be applied to Ukraine as well.

Clearly, the FTA as a form of regional economic integration will influence both Ukraine's environmental policy and bilateral cooperation on environmental issues and sustainable development. The absence of a universal model to describe the impact of liberalized trade on the environment means that, to establish fundamentally new forms of trading within FTAs, it is necessary to thoroughly analyze potential challenges to environmental safety and sustainable development.

This section looks at possible ways that Ukraine and the EU can cooperate in these two areas in the context of an FTA+ and evaluates the impact of its provisions on the stakeholders.

A brief overview of environmental policy

Sustainable development has been proclaimed a priority for Ukraine and enshrined in numerous domestic and international documents. Among others, Art. 50 of the Constitution guarantees citizens the right to an “environment that is safe for [their] lives and [their] health.” The conceptual underpinnings of Ukraine’s environmental policy, written into the Main Aspects of State Policy on the Environment, Natural Resources and Environmental safety,¹⁵⁸ are based on the country’s international commitments to implement “Agenda 21” and multilateral environmental conventions.

At the same time, a look at the current environmental situation makes it clear that sustainable development has not, in fact, become a state priority for Ukraine. Ukraine remains one of the few countries in Europe that does not have a national strategy on sustainable development or a national environmental action plan. Although the system of environmental legislation is based on the principles of EU environmental legislation, it generally does not provide for direct legal consequences. Environmental regulation is based on a diffuse and disorganized mass of “secondary” legislation—decrees, resolutions, instructions and so on. Typically, this huge bureaucracy leads to multiple interpretations of basic legislation and an unclear division of powers among the national, regional and sectoral levels. Some parts of Ukraine’s normative base that were inherited from the USSR are much more developed than their EU counterparts. This is particularly true of regulation governing the circulation of chemical substances and technologies that use chemical substances. However, actual practice in enforcing environmental legislation is both selective and symbolic, neutralizing any advantages.

The positive changes in some environmental figures are mainly due to a decline in the impact of humans on the environment, brought about by the collapse of the economy in the early 1990s and not to any structural improvements in the mechanisms for national development. The data in **CHART 16** shows that there is no clear trend towards an improvement in the environmental situation. Indeed, as economic growth picked up in the last few years, there are indications that the environmental situation has become even worse.

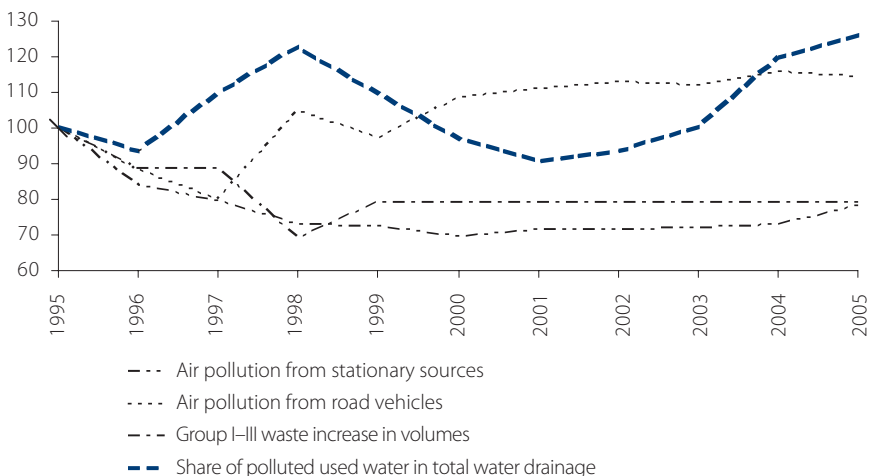
Until recently, the country’s environmental management system was in a state of continuous reorganization. This made coordination difficult and rendered decision-making both dilatory and ineffective. Only now is the Ministry of the Environment beginning to look like a consolidated center for public man-

¹⁵⁸ The document was adopted by Verkhovna Rada Resolution №188/98 – VR on 5 March 1998.

agement of the environment that is capable of strategically coordinating the activities of numerous subordinate agencies and offices.

Chart 16. Environmental indicators for Ukraine

1995=100



Source: Derzhkomstat; calculations by ICPS

When the economy is booming, this kind of approach not only critically aggravates environmental problems, but also keeps Ukraine behind in terms of how it handles such problems. The way environmental management functions remains incredibly weak. There is still no properly functioning dedicated environmental agency, which leads to the scattering of oversight functions among various ministries and agencies. Institutional reform aimed at improving the collection and analysis of environmental data remains slow, reducing the effectiveness of current environmental monitoring system. Although the state environmental reviews not only cover specific projects, but also strategic state programs and policies, they have little impact, since they focus on the qualitative and quantitative impact on natural resources, and not on the environment as an integrated system.

One of the most critical problems is funding for environmental policy and for incentives to develop eco-friendly technologies as a preventive measure. Existing environmental penalties fail not only to provide incentives for an environmental "logic" to resource management, but also to cover for damages incurred. There is also a paradoxical situation where, every year, there are complaints about the lack of funding for environmental policies, and yet independent audits show that there is systemic abuse of public funds.

The fact that Ukraine's institutional environmental policy mechanisms are not compatible with their EU counterparts deprives the country of one source of funding in this sphere. For instance, the price of certain imports from the EU to Ukraine includes the cost environmental measures, especially recycling, but because there is no mechanism to separate out this part, Ukraine loses these funds.¹⁵⁹

The use of instruments involving stakeholders, such as businesses, research institutes, NGOs, and local governments, in the formulation and implementation of environmental policy is also historically weak. Despite the establishment of a community council attached to the Environment Ministry—itsself an important step forward—, little information exchange circulates between the two bodies, and there is little openness or publicness in the decision-making process.

In the general range of political and socio-economic issues, environmental policy tends to be pushed to the periphery, as is demonstrated by:

- the domination of a sector-based approach to development issues;
- the untransparent and ineffective use of funds for environmental protection;
- a decline in the state's ability to solve environmental problems;
- the absence of political will to adopt and implement strategic decisions for sustainable development.

In short, the main problem in implementing environmental policy is the domination of a formalistic approach, to the detriment of impact and outcomes alike. Ukraine's environmental management is typified by ambitious and generally unreachable goals, the absence of a methods and effective instruments to attain them, and irresponsible management of financial resources.

In this kind of situation, rethinking the principles for forming and implementing environmental policy for sustainable development is not a mere component, but a prerequisite for Ukraine's further development as a sovereign state on the way to EU integration.

¹⁵⁹ See Report "A review of the use of monies from the State Environmental Fund over 2003 – 2005," which was presented to the Collegium of the Accounting Chamber on 6 December 2005.

How an FTA+ might affect environmental matters

The environmental impact of liberalized trade

The prospect of an environmental section in the future FTA between Ukraine and the EU could become a spur for systemic reform of environmental policy in this country. Because there are no complex models that might clearly describe the impact of liberalized trade on the implementation of environmental policy, an FTA + that is not limited to purely trade issues and encourages the reform of the entire public administration system could potentially stimulate positive changes in the approach to environmental protection as well.¹⁶⁰

Provided that adaptation to EU environmental standards is quick, the FTA + could become an effective and functional mechanism for capitalizing on the advantages of sustainable development for Ukrainian companies that trade externally. On the other hand, the additional costs to eliminate inconsistencies among standards, growing mandatory environmental fees, and lack of capacity to quickly adapt the business administration systems to the environmental management principles could reduce the competitive positions of Ukrainian companies on the EU and domestic markets alike.

Liberalized trade between the European Union and Ukraine will stimulate the development of a new segment in the domestic market of goods and services, the "ecoproducts" market. Despite considerable technological potential in this area, Ukrainian producers stand to lose the battle to their more experienced European competitors even as this new market forms.

The formation of a new model of economic cooperation with the EU under an FTA + should stimulate a wide application of market incentives and economic mechanisms to solve environmental problems, and cut down on strictly administrative instruments. Innovative elements such as trading emission credits should become central to environmental economic policy.

The main impact that free trade between Ukraine and the EU might have on environmental policy includes:

- better environmental policy;
- a new market for environmental goods and technologies;

¹⁶⁰ Trade flows and liberalized trade have both a physical and an economic impact on the environment and development. The structure of this impact can be analyzed based on specific trading conditions. Under standard free trade, international trade has little impact on a country's environmental regulation systems. But analysis shows that deep free trade offers far more opportunities to reform environmental regulation and control systems.

- more positive contribution of environmental factors to business competitiveness;
- innovative instruments connected to international trade in domestic environmental policy, especially systems of trading in wastes and industrial emission credits.

Better environmental policy

The development of environmental policies in Central European (CE) countries during their EU integration was governed by the need to make their policies compatible with their EU counterparts. This is considered one of the main stimuli for modernizing public administration among candidates for membership in the Union. Minimizing the negative impact of this harmonization on economic development and competitiveness became a priority issue for these countries.

For the new EU members, transposing EU environmental priorities and quickly incorporating its standards required considerable private and public investment, the larger part of which had to be from domestic sources. In addition, EU environmental policy requires an exceptionally competent government, able to transpose and institute complex technical and procedural rules and to define, plan, finance and oversee the execution of investment programs.

Given this and current realities in Ukraine, the signing of an FTA+ might not only fail to become the means to automatically switch to EU environmental policy standards, but could actually generate new challenges to sustainable development,¹⁶¹ including:

- **ECONOMIC CHALLENGES.** Solving the priority economic objectives of the environmental policies, such as reducing energy consumption in GDP and limiting hazardous wastes, will require significant investment. This could cause fiscal distortions and give rise to sector-based lobbying for regulations with “non-environmental content.” Raising mandatory environmental fees will increase production costs for many domestic industries, reducing their competitiveness.
- **INSTITUTIONAL CHALLENGES.** Those government agencies that are responsible for implementing environmental policy will be faced with the problem of effective use of additional funds and institutional competence to spend such money, transparently. Environmental ministries and institutions traditionally lack political force and influence to prevent sector-based distortions in the formation and implementation of state policy. Apart from that,

¹⁶¹ Vovk, V., “The Accession of Central and Eastern European states to the EU: Impact on environmental policies and prospects for sustainable development (Lessons for Ukraine).”

the democratic deficit and the low level of public participation in Ukraine complicate the mobilization of social support for implementing an often-costly environmental policy.

- **POLITICAL CHALLENGES.** The effort to muster political will and support to introduce a tough environmental policy will likely face pressure from political forces representing the interests of Big Business, at all levels of the legislative and executive branches. Ukraine's weak "green" parties and community organizations, which are traditional in European civil society, could fail to effectively consolidate political circles around the idea of sustainable development.

At the same time, an FTA+ would give Ukraine effective instruments for avoiding the disadvantages of a one-sided integration process. Smart harmonization with current EU environmental legislation would be an undisputed advantage if it took place selectively, reflecting Ukraine's legal commitments and its national interests, circumstances and capacities. Ukraine would have a greater advantage and better prospects if it showed some initiative in drafting a sustainable development strategy, especially if the country adopted the EU's innovative environmentally-oriented economic policy to match national conditions and objectives.

Thus, the inclusion of environmental issues and cooperation in environmental policy into the FTA+ would be a continuation of the EU's main practice and would have a positive effect on the speed of environmentally-oriented economic reform in Ukraine. This is in line with commitments on both sides to increase capacity and move development ahead.

A new market for environmental goods and technologies

In international trade, the environment is seen less as a separate sector than as an agglomeration of suppliers of different types of goods, services and technologies that are typically an integral part of the production process and are thus not distinguishable as separate components.¹⁶² Similarly, ecological products are not a separate group but can be characterized as an aggregate of separate elements of trade classifications.

The term "ecoindustry" is defined as "activities directed at the production of goods and services designed to measure, prevent, limit, minimize or repair environmental damage to water, air and soil, as well as the problems of ecosystems connected to wastes and noise. This includes cleaning technologies and prod-

¹⁶² See *Industry, Technology and the Environment: Competitive challenges and business opportunities*, US Office of Technology Assessment, OTA ITE 586, US Government Printing Office, Washington, DC, p. 149.

ucts and services that lower environmental risks and minimize the pollution and exploitation of resources."¹⁶³

Based on this classification, the team of an Informal OECD/Eurostat Working Group formed a preliminary list of ecological goods and services in 1998, using the six-digit codes of the HS system, which included a total of 164 nomenclatures. Later, APEC, an Asian trade group, suggested its own classification of ecological goods, which differed in a number of aspects. However, a final, generally accepted list at the WTO level or through another union of states has still not been formed.

In the early years of the 21st century, Ukraine is only beginning to form a market for ecological goods as a component of the domestic economy and the international ecoproduction market, the value of which is currently estimated at more than EUR 550bn.¹⁶⁴ According to independent experts, the most competitive market segment of the ecoindustry was formed in the European Union by the end of the last century. The annual scale of the EU-15 ecomarket had reached an average of more than EUR 500 per person by the end of the century.¹⁶⁵

At the same time, the ecomarket of the new EU members is only worth about EUR 10.3bn, of which EUR 5.5bn is in investments and only EUR 4.8bn is the actual value of ecogoods and ecoservices. Direct employment in the new EU Member States' ecoindustry is estimated at 770,000 persons, of which more than 50% are employed in waste management. The average value of ecoproduction per person was only EUR 66.

From the point of view of international trade, the EU ecoindustry is the most diverse and powerful ecosector in the world, significantly exceeding even those of such recognized centers of economic power as the US and Japan. The total value of ecological exports from the EU is as much as EUR 18bn a year. According to ECOTEC, European companies are leading in such sub-sectors of the environmental segment of the market as new energy technologies and pollution prevention. Despite the fact that the markets of the "Triad" states—the US, Canada and Japan—remain the EU's main trade partners in ecoproduction, experts say that growth is exploding in the trade of ecological goods with the new EU members and the candidate states, stimulated by the candidates' commitments to adapt their legislation to the EU *acquis*. Predictions are that real ecomarket growth in these countries will remain around 5–8% in the coming years, while the pace of real growth among developed markets be about 1–3%.

¹⁶³ OECD Industry, Services & Trade, *The Environmental Goods and Services Industry: Manual for Data Collection and Analysis*, ISBN 9264171096.

¹⁶⁴ See Olha Popova "Ecology enters the market," *Dzerkalo tyzhnia*, № 40 (364).

¹⁶⁵ *Analysis of EU Eco-Industries, their Employment and Export Potential*, A Final Report to DG Environment (Ref: 08/03/02), ECOTEC Research & Consulting Limited.

In this situation, the mutual opening of markets by Ukraine and the European Union could lead to:

- **AN INCREASE IN ECOPRODUCTION EXPORTS FROM THE EU TO UKRAINE**, since demand for ecological technologies and solutions cannot be satisfied by domestic producers in the next few years.
- **INCREASED ACTIVITY AMONG EUROPEAN COMPANIES IN UKRAINE**, in particular through joint ventures with Ukrainian partners and growing investments in new environmental projects in Ukraine.
- **A SHIFT IN ECOINDUSTRY JOBS FROM THE EU** (including the new members) to Ukraine through the expansion of industries to satisfy demand on the Ukrainian market and develop export potential among the European companies for third country markets.

The positive consequences for Ukraine could include: quick institutionalization of the ecomarket, more classifications and lower costs of ecogoods and services, less time and resources needed to use them, and more new jobs. At the same time, the growing Ukrainian ecobusiness could, even as it establishes itself, lose the race for both the domestic market and the foreign consumer. The actual outcome will depend on how prepared individual sectors are to compete with EU producers.

Environmental factors and business competitiveness

The Action Plan for the 21st century, adopted back in 1992,¹⁶⁶ states that environmental management must be included among the key elements of sustainable development and at the top of the priority list for industries and business as a whole.

The signing of an FTA+ between Ukraine and the EU will bring to the forefront the matter of finding ways to continually improve production and marketing technologies to be compatible with the free circulation of goods and international competition. In EU countries, among the most promising and innovative approaches to make businesses more competitive and simultaneously minimize the human impact on the environment are the emergence of voluntary environmental activities and the development of environmental management systems.

Ukraine is already seeing new instruments to increase competitiveness through environmental standards being formed and they correspond to the best EU models:

¹⁶⁶ "A Plan of Action: Agenda 21 and documents from the Conference in Rio de Janeiro," edited by M. Keating, Geneva, For Our Common Future Center, 1993, 70 pp.

- **A SYSTEM OF NATIONAL STANDARDS** based on the worldwide ISO system. However, there is some problem with their incompatibility with EU standards and their mutual non-recognition.
- **A SYSTEM OF ECOLOGICAL PRODUCT MARKING**, in accordance with the ISO 14024 standard—ecological marking, type 1. The Ukrainian sign for “Environmentally clean and safe” is now included in the international registrar of the Global Ecolabelling Network and is recognized by 35 states, including the EU.
- **CERTIFICATION INFRASTRUCTURE** for environmental management systems (EMSs) with most components recognized at the EU and world levels to be introduced in Ukraine.

At the same time, analysis indicates there are a slew of circumstances that will slow down the development of EMS in Ukraine:

- lack of understanding or denial of environmental impact among business leaders;
- limited resources at domestic industries (financial, time, human);
- lack of external incentives to introduce EMS;
- lack of skills and methods;
- insufficient support and supervision in introducing EMS according ISO and EMAS standards.

The experience of major companies shows that introducing EMS leads simultaneously to a decrease in negative impact on the environment, less money spent on materials that are used in production, and savings on energy. This all reduces production costs and makes the company more competitive. In addition, EMS is seen as an inseparable part of overall management systems that are based on modern information technologies.

This issue needs to be discussed separately as regards Ukraine's farm sector. The available natural resources and the way they are used indicate that Ukrainian growers have a potential competitive edge in a very promising world market of organic food. Instituting internationally recognized EMS is a mandatory condition, not an option, in order to see this potential fulfilled. This requires a coordinated effort on the part of producers, that is, businesses, and the relevant state agencies.

Broad implementation of effective systems for monitoring product quality and competitiveness underpinned by environmental factors could make Ukrainian industries far more effective under an FTA+, both on the domestic and the EU markets. In terms of free trade, the need to join the EU market and to maintain competitive positions will stimulate their development in Ukraine in the nearest future.

Trading in waste as an innovative instrument

Once an FTA+ is concluded with the EU, a mutually beneficial system of trading special goods, in particular products and substances classified as "wastes," and, beyond, a system for trading in emission credits should develop more quickly.

Moreover, the liberalization of trade could indirectly spur both interstate contracts on storing and utilizing hazardous wastes and illegal import and export operations with such materials. There have been cases when dangerous wastes were sold—illegally—as recycled materials to Ukrainian companies that were physically and technically incapable of storing or using it. This led to unsanctioned storage places containing hazardous substances of questionable origin.

An FTA could also potentially foster the export of recycled materials and scrap steel from Ukraine. The gradual reduction in export duty that will start in relation to agreements on Ukraine's accession to the WTO and the FTA will spur scrap exports, which could have a negative impact on the delivery of strategic raw materials to domestic manufacturers. It will also reduce Budget revenues in Ukraine over the next few years.¹⁶⁷ On the other hand, a gradual decrease in export duty could also strengthening Ukraine's position in negotiations with the EU on the open access of domestic steel products to the EU market.

Finally, an FTA+ should stimulate the further development in Ukraine of a domestic system for recycling wastes. The obvious economic advantages of reducing resource consumption and, consequently, production costs should stimulate exporters to manage their own wastes more efficiently to complete the "materials – products – wastes" cycle and maximize the return of wastes to useful production. Tax benefits for companies that collect, store and sell wastes as recycled materials—given only in the last instance—, should stimulate the development of a complete resource use cycle at the national level. This, in turn, would have a positive impact on solving both economic and environmental problems associated with the accumulation and use of wastes.

The potential advantage of joining the Kyoto Protocol is considered very high for Ukraine. Although exact numbers are unknown, Ukraine is likely to have a huge surplus of emission credits, which will eventually become available for international trade. According to preliminary estimates, emission credits could amount to 2bn t between 2008 and 2012. The selling of these credits through Joint Implementation (JI) or trade in emission credits projects under the Kyoto Protocol is a promising source of funding for environmental innovations at all levels, from companies and sectors to territories and nations.¹⁶⁸ Most important

¹⁶⁷ An explanatory note to the draft Verkhovna Rada Resolution "On the unacceptability of the Bill of Law of Ukraine 'On amending Art. 1 of the Law of Ukraine "On export duty on wastes and scrap steel."'"

¹⁶⁸ "The prospects of deep free trade between the EU and Ukraine," CEPS/IFW/ICPS, 2006.

is that these mechanisms offer the possibility of introducing a real economic dimension to environmental policy—to give it a market value.

Ukraine is already preparing projects to limit wastes, which could be compatible with the JI requirements, that is, include foreign investments, based on considerable potential in electricity, coal, steel and forestry. The first JI projects have already been approved and implementation is under way. A national survey of the level of wastes Ukraine can trade is almost completed.

When designing its domestic system of selling credits, Ukraine should consider its status as a country with surplus, that is, a donor. The EU is short on credits and the system of selling credits recently introduced in the EU is designed for trading under deficit conditions. During public consultations, the opinion was expressed that for Ukraine to join or adapt to the EU system would be against national interests. Still, Ukraine has very little time to introduce an institutional mechanism for trading in credits. Preparations need to be completed within the year, as Kyoto mechanisms kick in on 1 January 2008. A major push needs to be undertaken so that this enormous potential is not lost.

Regulating access to the domestic market

Ukraine could also use this opportunity to master a new instrument for regulating the entry of different types of goods to its market by establishing environmental safety standards. With the right provisions, new agreements on technical barriers to trade and on sanitary and phyto-sanitary measures should allow Ukraine to use scientifically justified environmental safety standards. Such standards could become the means to limit access for certain goods to the Ukrainian market, which would be in the best interests of Ukrainian consumers and producers alike.

The FTA+ impact on stakeholders

A model for how trade and environment interact

When analyzing and predicting the impact of deep free trade in environmental matters, the fact is that, so far, there are no models to describe the correlation between trade, environment and development. Depending on the sector, the country, the market and the policies, trade and its liberalization can have both a positive and a negative impact on the environment and development. In fact, these factors act simultaneously, leading to positive consequences on the one hand, and negative ones on the other for different players in the economic equation.

Trade flows and liberalized trade have both a physical and an economic impact on the environment that can be divided into at least four types:

- product impact;
- technological impact;
- impact of scale of commercial activity;
- structural impact.

Product impact is what happens from products that are being circulated in trade. Some positive results of trade could be expanded use of new, environmentally-friendly technologies and support for the speedier adoption of goods or technologies that have less of an impact on the environment. A country's policy of openness to trade and investment could also contribute to economic development plans, fostering the transition to progressive technologies and management systems. In a negative sense, trade could stimulate the cross-border movement of goods that, from the environmental point-of-view had better not enter countries that do not have the necessary technical and administrative capacities and are often unable to assess the acceptability of any risks. Trade can also lead to excessive exploitation of specific resources, bringing them to the edge of exhaustion. Domestic demand alone rarely leads to such an outcome.

Technological impact is the impact of liberalized trade on the transfer of technologies and production processes used in making export goods. Technologies have a positive impact when their use leads to less pollution. Economic growth, stimulated by trade, and market competition through the liberalization of trade can generally speed up the modernization of fixed assets and technologies. Theoretically, new markets ensure both Budget revenues and capital inflows, allowing companies to increase the pace of circulation of capital and to invest money in cleaner, more efficient companies, technologies and industries.

On the other hand, liberalizing trade and expanding markets can have a negative impact on more environmentally friendly and socially-oriented traditional

technologies. Liberalization can also encourage the spread and use of dangerous, dirtier technologies. In general, other market factors that affect the acceptability and choice of technologies, such as prices and domestic environmental legislation, will largely determine whether technological impact is positive or negative for the environment.

Growing economies of scale, which generate additional wealth, can have a positive impact on both environment and development. First, growing economic efficiency can directly affect the environment, since companies that work efficiently need fewer natural resources and generate less pollution and waste. Secondly, increased efficiency can have an indirect impact on the environment. When people become more prosperous, they begin to demand stronger environmental protection. Yet most types of commercial activities have a destructive impact on the environment: extraction of raw materials, waste storage and persistent pollution. Increased economic activity leads to a negative impact on the environment unless operating legislation guarantees that additional economic activity will not bring about losses. This is unlikely.

Liberalizing trade can also lead to changes in the structure of the domestic economy. Its positive impact on the environment is significant only when the share of heavily polluting sectors is reduced. Trade with countries where consumers demand environmentally clean products can also change the structure of the economy, provided that exporters start developing new products to meet this demand. The potential favorable consequences for the environment are obvious. The abolition of subsidies, quotas and other restrictions that encourage specialization can become a positive outcome of liberalization. On the other hand, liberalization can also have negative consequences if the country specializes in production that is based on natural resources or on polluting technologies, because its share in the economy will grow. Without a corresponding environmental policy, this would mean an increase in pollution or in excessive exploitation of natural resources.

Adapting the model and its impact on stakeholders

The influence of stakeholders on reforming environmental policy will be a significant factor in successful change in many spheres. While opening prospects for a better system of environmental policy and ecomanagement at the level of companies, sectors and the domestic economy as a whole, a Deep Free Trade Agreement between Ukraine and the EU will also represent a number of real threats for certain stakeholders.

Obviously, the impact of liberalized trade on the environment will be noticeable not only during economic transactions, but also in the activity of non-business groups, in particular local communities and the third sector. These tend to be primarily interested in increasing prosperity and improving the environment.

Determining the interests of all parties concerned and taking them into consideration when making decisions is a mandatory condition to follow the long path to a deep free trade area with the EU with the greatest efficiency and effectiveness. A number of stakeholders have been identified:

- Ukrainian SMEs producing for the local consumer;
- major producers of goods and exporters;
- European companies interested in expanding their business in Ukraine;
- regulators and central and local executive bodies;
- the public (direct consumers of environmental benefits) and community associations.

Analysis according to stakeholders

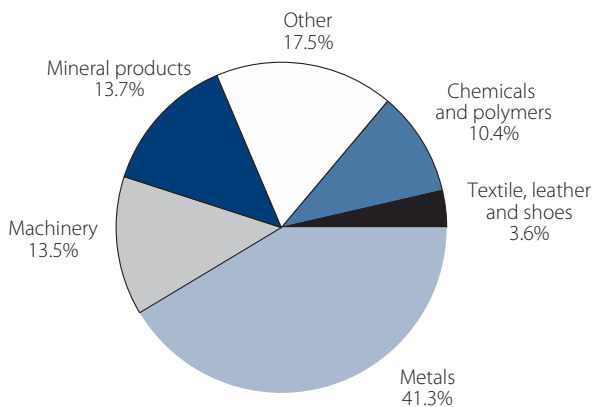
Stakeholder	Pros	Cons
SMEs	Lower prices and a wider variety of resource- and energy-saving technologies A growing domestic market of ecological goods	A weakening competitive position due to the environmental component of production (works, services)
Major manufacturers and exporter	Reduced power consumption during production The development of integrated production management systems and environmental management systems Greater competitive advantage for products in EU markets after introducing a single environmental standard Participation in joint implementation projects under the Kyoto Protocol	Excessive exploitation of natural resources as low value-added exports increase Increased costs to follow ecostandards and pay ecotaxes; the loss of current competitive advantage Insufficient internal investment to upgrade production Increased pressure from foreign companies with more progressive production technologies
Foreign companies	Domination on ecoproduction and ecoservices markets	Increased competitive pressure from some domestic producers
Government/ administrative bodies	Increased funding (also from the outside) for environmental programs A growing role for the environmental component in public administration The formation of the national strategy and the plan of actions on sustainable development	Inefficient use of financial resources in reforming environmental policy Resistance to environmental reforms by sector-based lobbies The costs of harmonizing the legal field with the EU norms
The public and community associations	Less energy and resource consumption overall An increased role for NGOs in forming environmental policy A return of the idea of sustainable development to political platforms Greater activism in local assemblies to ensure "ecojustice"	The lack of real leverage to resist the sector-based lobbies when adopting environmental policies The loss of certain environmental benefits as businesses refuse to finance environmental infrastructure



Appendices

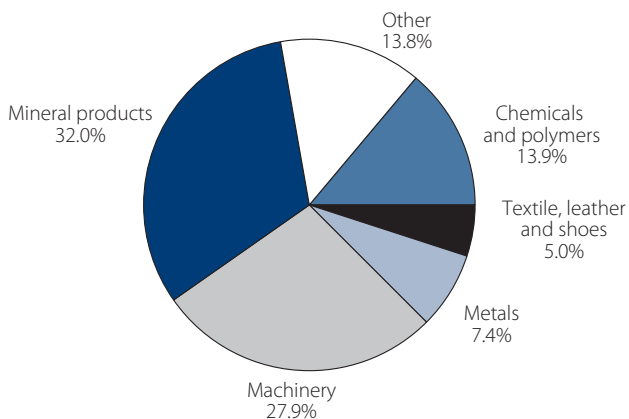
Statistics for Ukraine's trade in industrial goods

Chart 1.1. Commodity structure of exports, 2005



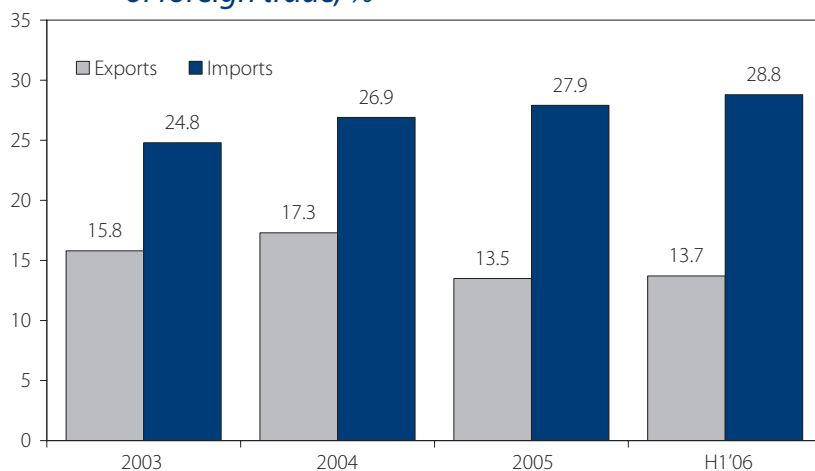
Source: Derzhkomstat

Chart 1.2. Commodity structure of imports, 2005



Source: Derzhkomstat

Chart 1.3. Share of machine-building in commodity structure of foreign trade, %



Source: Derzhkomstat

Table 1.1. Trade in machine-building products with the EU, mn EUR

	2001	% of exports/ imports to/from EU	2003	% of exports/ imports to/from EU	2005	% of exports/ imports to/from EU	Share of total EU exports/ imports, %
Exports from Ukraine to the EU							
Machine-building, including:	310	5.8	628	11.0	588	7.7	0.33
Machinery	181	3.4	275	4.8	400	5.2	0.14
Transport equipment	129	2.4	353	6.2	188	2.5	0.19
Total exports to the EU	5,276	100.0	5,715	100.0	7,666	100.0	0.65
Imports from the EU to Ukraine							
Machine-building, including:	2,598	37.3	3,542	67.3	5,754	44.1	2.25
Machinery	1,860	26.7	2,404	27.2	4,342	33.3	1.41
Transport equipment	738	10.6	1,138	12.9	1,412	10.8	0.84
Total imports from the EU	6,967	100.0	8,830	100.0	13,033	100.0	1.23

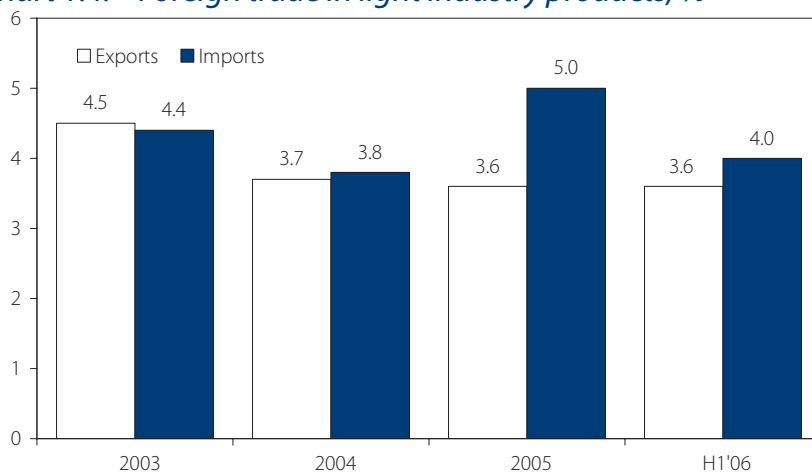
Source: Eurostat

Table 1.2. Trade in chemical products between Ukraine and the EU, mn EUR

	2001	% of exports/ imports to/ from EU	2003	% of exports/ imports to/ from EU	2005	% of exports/ imports to/ from EU	Share of total EU exports/ imports, %
Export	498	9.3	493	8.6	499	6.5	0.53
Import	1,007	14.4	1,323	15.0	1,997	15.3	1.22

Source: Eurostat

Chart 1.4. Foreign trade in light industry products, %



Source: Derzhkomstat

Table 1.3. Trade in textiles and clothing with the EU, mn EUR

	2001	% of exports/ imports to/from EU	2003	% of exports/ imports to/from EU	2005	% of exports/ imports to/from EU	Share of total EU exports/ imports, %
Export	473	9.0	478	8.4	468	6.1	0.67
Import	635	9.1	699	7.9	824	6.3	2.50

Source: Eurostat

Table 1.4. EU imports from Ukraine, 2005

Products	mn EUR	%	% of total EU imports
Materials	2,415	31.5	2.1
Semi-finished products	1,171	15.3	2.6
Mineral products	1,048	13.7	0.4
Machinery and transport equipment	588	7.7	0.2
Chemical and related industries	499	6.5	0.5
Other	1,251	23.7	5.5
Total	7,666	100.0	0.7

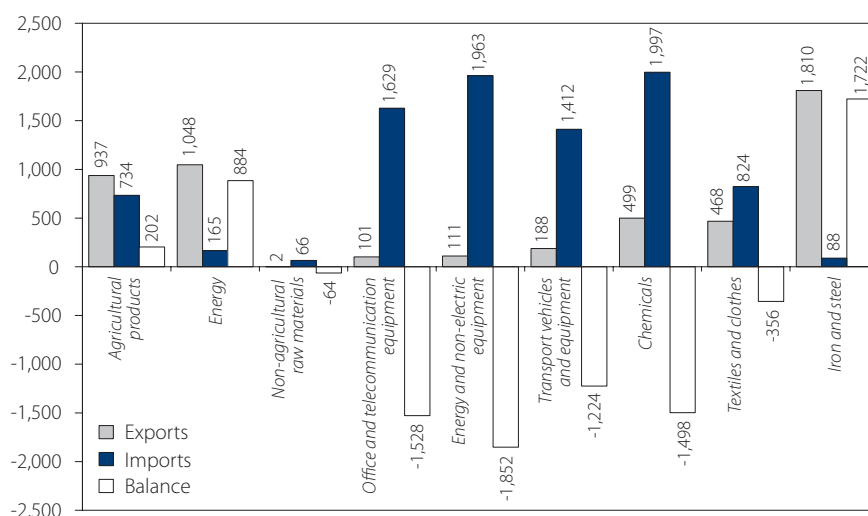
Source: Eurostat

Table 1.5. EU exports to Ukraine, 2005

Products	mn EUR	%	% of total EU imports
Materials	2,087	16.0	1.6
Semi-finished products	209	1.6	1.1
Mineral products	165	1.3	0.4
Machinery and transport equipment	5,765	44.2	1.2
Chemical and related industries	1,997	15.3	1.2
Other	8,410	31.6	3.6
Total	13,033	100.0	1.2

Source: Eurostat

Chart 1.5. Commodity structure of trade with EU, 2005, mn EUR



Source: Eurostat

State aid to machine-building sectors

Shipbuilding

According to **Law №1242–XIV “On measures related to state aid for the shipbuilding industry in Ukraine” of 18 November 1999**, the shipbuilding industry was granted tax breaks. In effect from 1 January 2000 to 1 January 2005, these breaks included:

- deferred payment of corporate profit tax;
- no import duty;
- no VAT on imported components;
- zero VAT rate on domestic operations to sell products manufactured for Budget funds;
- no VAT on planning and design works;
- no land tax.

The list of companies eligible for exemptions, other than companies registered in SEZs, was adopted by the Cabinet of Ministers. Since the 2005 State Budget was passed, shipbuilders **are exempted only from excise duty**.

Notably, Art. 21 of the Law “On measures related to state aid for the shipbuilding industry in Ukraine” instituted state financial support for building sea and river vessels, and other floating vessels, and reconstructing basic production facilities of shipbuilding companies through discounted loans, that is, partial compensation of commercial bank loan rates, for the period 1 January 2005 to 1 January 2012. The funds to provide this type of financial support for the shipbuilding sector are allocated yearly in the State Budget Law, in compliance with the Budget Code, and transferred to companies identified in Art. 1 of this Law.

Analysis of the practice of indirect subsidies for domestic shipbuilding as to compliance with WTO and EU norms leads to these conclusions:

1. An identified list of companies receiving subsidies is evidence of targeted subsidies. According to WTO rules, such subsidies belong to the category “give grounds to implement measures,” that is, to institute trade restrictions.
2. The cancellation of tax exemptions in 2005 was, in fact, an attempt to adjust the state aid system to EU norms, as tax exemptions constituted operational support for shipbuilders.

On the other hand, cancelling tax exemptions cut into working capital during the production cycle, which could lead companies to refuse to build fully-equipped vessels and to switch to simple assembly of hulls. This, in turn, is likely to result in shrinking orders, a decline in output and a poorer structure of output, job cuts in the sector, and reduced Budget revenues.

Car-making

For a long time, Ukraine's car-making industry was one of the main beneficiaries of subsidies. **Law №535/97–VR "On incentives for car-making in Ukraine"** of 19 September 1997 granted these tax exemptions:

- no corporate profit tax, that is, an exemption on that part of profits that was re-invested and used to repay loans during the implementation of the investment project;
- no import duty or VAT on imported equipment and components;
- zero VAT rate on domestic sales operations;
- no excise duty;
- no land tax.

The law clearly identified the criteria for receiving benefits: an investment equivalent to at least US \$150mn in the production of passenger cars, at least US \$30mn in the production of trucks and buses, and at least to US \$10mn in the production of components for cars and buses. These conditions made clear the targeted nature of these subsidies, as the only company eligible from the very beginning was ZAT Zaporizhzhia Car Plant [AvtoZaz Daewoo]. Since late 2003, ZAT L'viv Car Plant [LAZ] also became eligible.

This special treatment was supposed to have remained in effect until 1 January 2008. However, nearly all exemptions, except for import duty, were **cancelled in the Law "On the 2005 State Budget."**

However, **Law №1624–IV "On the development of the car-making industry"** of 18 March 2004 left tax exemptions established by **Law №535/97–VR "On incentives for car-making in Ukraine"** of 19 September 1997 in place for companies whose investment programs were approved by the Cabinet of Ministers before 1 January 2004, that is, for the two main companies in this sector: AvtoZAZ and LAZ.

In addition, the Law "On developing the car-making industry" provided corporate profit tax and import duty exemptions for companies that produce cars, motorcycles and/or components and spare parts where Ukraine is the country of origin, with the proviso that the cost of used units and components originating from other countries be less than 50% of the producer price for a given item.

Import duty is also not collected from the two companies' imports of goods and components to manufacture cars, motorcycles, components and spare parts originating in Ukraine, effective until 31 December 2008. In 2005, the country of origin criterion and the related exemption from import duty were withdrawn.

Analysis of the practice of subsidies for the domestic car-making industry shows that the mechanisms do not comply with WTO norms:

- **the clearly targeted nature of the subsidies**, limited to two beneficiaries;
- most remaining tax exemptions for these two companies aim at **covering operating expenses** (operational support). This particular type of support has the most negative impact on competition and is banned by EU norms;
- WTO rules prohibit the use of measures that provide incentives for a company to purchase or use domestic products. Specifically, it is prohibited to establish a norm that implies that a company receives certain advantages and benefits if the cost of domestic products in the company's total production costs constitutes no less than a regulated percentage (Art. 2 and item in the Annex to the Agreement on Trade-Related Investment Measures [TRIMs]). The use of such measures is viewed as a violation of a key WTO requirement, the commitment regarding **domestic conditions**.

On 3 August 2006, the Cabinet of Ministers issued Instruction №452r "On approving a concept for developing the car-making industry and regulating the car market until 2015." The goal in this concept included such important priorities as promoting domestic products on the international market and increasing the efficiency of manufacturing competitive cars by modernizing operating companies and setting up new ones. The main objectives of this concept are:

- to integrate domestic companies that make components, units, assemblies, and spare parts into the global car-making system;
- to establish new companies to make cars, components, units, assemblies, and spare parts, involving investors, especially foreign investors.

In addition, with Ukraine's anticipated accession to the WTO, according to this concept, it is possible to expect that:

1. the investment appeal of this sector will grow;
2. exports of cars, components, units, assemblies, and spare parts will rise;
3. domestic technical standards for cars will be harmonized with international norms;
4. domestic and foreign car-makers will compete more on the domestic market.

These starting principles give reason to expect that, with the institution of an FTA with the EU, Ukraine will be included in trade networks, especially in the EU's production and supply chains. The main factors that might accelerate this process are proximity to the EU market, low-cost labor and a potentially

attractive, large domestic market. In addition, domestic scientific developments in more efficient fuel consumption could also appeal to investors.

The international Vehicle Certification Systems include procedures for being granted **"Vehicle Type Approval."** In EU practice, Vehicle Type Approval can be granted provided that there is confirmation of compliance with specific safety requirements—the rules of the United Nations Economic Commission for Europe (UNECE) and EU Directives—that are effective within each individual country. Ukraine acceded to the 1958 Geneva Agreement with the passing of Law №1448 – III "On Ukraine's accession to the 1958 Agreement on the Adoption of Uniform Technical Prescriptions for Wheeled Vehicles, Equipment and Parts fitted and/or used on Wheeled Vehicles and the Conditions for Reciprocal Recognition of Approvals granted on the basis of these prescriptions amended as of 1995" dated 10 February 2000. To fulfill Law №2406 – III "On confirmation of compliance" of 17 May 2001, the Ministry of Transport must develop and approve **technical regulations on confirming the compliance of road vehicles.**

In the absence of such technical regulations to establish the procedure for receiving Vehicle Type Approval in Ukraine—a list of products subject to confirmation of compliance, the extent of requirements, conditions for confirming compliance, and so on—, **it is currently impossible to determine the cost of certifying** products made in this sector with regard to international safety requirements.

Aircraft construction

According to Art. 3 of Law №2660 – III **"On state aid to the aircraft industry in Ukraine"** of 12 July 2001, the government implemented certain support measures for the period 1 January 2002 to 1 January 2007:

- no import duty on materials, components and equipment used for developing and manufacturing airplanes and for providing service to other companies, provided that such goods are not manufactured by companies on Ukrainian territory or when such that are do not meet international standards or the requirements of the customers of products or services as stated in the terms and conditions of their contracts. The Cabinet approves the list and the extent of contracts for these goods, except for excisable goods, annually, based on contracts signed by these companies;
- breaks on the land tax: full exemption for 2002, 50% reduction for 2003 – 2004;
- no tax on operations to import materials, components and equipment, except for excisable goods, used for developing and manufacturing airplanes and providing service to companies, provided that such goods are not manufactured by companies on Ukrainian territory or when such that are do not meet international standards or the requirements of the customers of products or services as stated in the terms and conditions of their contracts. The Cabinet

approves the list and the extent of contracts for these goods, except for excisable goods, annually, based on contracts signed by these companies.

As it happens, the **2005 State Budget Law** dropped these tax breaks, except as regards excise duty.

To speed up negotiations and fulfill the provisions of Presidential Decree №797 "**On additional measures to accelerate Ukraine's accession to the WTO**" of 5 September 2001 and the Program of Measures to Complete Ukraine's Accession to the WTO approved by Presidential Decree №104 of 5 February 2002, Ukraine undertook a commitment to joint 16 sectoral agreements and initiatives, including the Agreement on Trade in Civil Aircraft¹⁶⁹ (ATCA) as of 2010. The text of the protocol with the EU does not refer to accession to **ACTA**. However, the Annex on Access to Markets of Goods establishes a zero import duty for products covered by this agreement starting in 2010.

Aerospace

According to Law №1559 – III "On state aid for space activity" of 16 March 2000, four state aid measures were in effect from 1 January 2002 to 1 January 2007:

- no import duty on goods entering Ukrainian customs territory in order to manufacture aerospace machinery and equipment, including assemblies, systems and their components for space stations, carrier rockets, spacecraft, and ground-based segments of space systems, provided that such goods are not manufactured on Ukrainian territory. The Cabinet identifies the list of such goods, except for excisable goods, indicating their codes according to the Harmonized Commodity Description and Coding System, and the procedure and volumes for importing them;
- no VAT on operations to sell space laboratories, carrier rockets, spacecraft, ground-based segments of space systems and their assemblies, systems, and components manufactured by entities involved in aerospace;
- no tax on operations by entities involved in aerospace to import goods onto Ukrainian territory used to manufacture space machinery and equipment, provided that such goods are not manufactured on Ukrainian territory;
- no land tax for companies in this sector, as approved by a list from the Cabinet.

This beneficial tax treatment was supposed to be in effect until 1 January 2009. As with other sectoral support programs, however, all benefits and exemptions, except for excise duty, were dropped in 2005.

¹⁶⁹ This Agreement was signed over 12 – 14 September 1973 and covers: all civilian aircraft, all civilian aircraft engines, their parts and components, all other parts, components and sub-assemblies of civilian aircraft, all ground-based flight simulators, their parts and components.

The impact of EU agreements on specific CE machine-building sectors

Shipbuilding

Prior analysis of the impact of EU accession of five countries—the Czech Republic, Estonia, Hungary, Poland, and Slovenia—predicted a decline in competitiveness in the shipbuilding and ship-repair industries in all these countries. The main reasons cited were:

- fulfilling the requirements of the *acquis* regarding environmental protection;
- growing labor costs and the kicking in of the social block of the *acquis*;
- growing production costs due to instituting EU regulatory norms regarding occupational safety and health.

All this resulted, in growing investment in the sector, on one hand, and growing operating costs, on the other.

Cooperative networks or arranging an effective supply chain

Efficient logistics and an effective cooperation system can have a major impact on reducing production costs. Before accession, Polish shipbuilding and ship-repairing companies could count on imports of components to stabilize at 10–15%, whereas the volume of such imports was nearly 25% in late 1990s. Estonian companies in this sector satisfied demand for components using domestic suppliers and the share of imported materials was only 10% in 1999.

Generalized comparisons of production costs in the shipbuilding sector (see **TABLE 3.1**) show a high level of production costs in the Old EU Member States, which gave a comparative advantage to CE countries, especially Poland.

Buyers

From 1990 on, Poland's share of domestic sales has been shrinking. Polish shipowners did not place orders with Polish shipbuilders because of high lending rates at local banks and high VAT and import duties on imported materials and equipment. By the late 1990s, 95% of vessels were manufactured for export, including 80% for the EU. 80% of ship-repair services were provided on an export basis—60% to the EU and Norway alone.

Table 3.1. Production costs of shipbuilding companies

(1997, average global production costs = 100)¹⁷⁰

Country	Index
China	50
The US	155
Western Europe	140
Japan	150
South Korea	110
Scandinavia	142
Southern Europe	130
Black Sea/Balkan countries	115
Southeast Asia	77
The UK	138
The Middle East	97
Central Europe (e.g. Poland)	115

Czech shipbuilding companies received many orders from German and Dutch naval companies, while Estonian companies exported to Denmark, Finland, the Netherlands and Norway.

Access to financing

In 1990s, Polish shipbuilding companies began actively turning to local and foreign banks for loans and bank guarantees, hoping to finance production for export and capital investment. A widespread problem among the studied countries was a high interest rates compared with profit margins in the shipbuilding and ship-repair industries.

SWOT analysis

The key **strengths** of CE countries were price competitiveness and highly skilled workers. In the case of Poland, a key strength was its relatively large share of the global market. **Weaknesses** included outdated production facilities, insufficient R&D spending, and lack of an effective strategy for environmental protection.

Key **opportunities** for all five candidates were secured by a stable macroeconomic environment, free trade with the EU, and a high level of competitiveness—mainly on prices—, thanks to low labor costs. The main **threat** was rising wages.

¹⁷⁰ "The Shipbuilding and Ship Repair Sectors in candidate countries: Poland, Estonia, the Czech Republic, Hungary and Slovenia," NOBE Independent Center for Economic Studies, www.nobe.pl.

The impact of enlargement on the car-making industries of New Members and Candidates

The accession of 10 new member states to the EU led to growing investment in Central Europe and Turkey. The opening of new plants for assembling cars was followed by the establishment of plants for manufacturing spare parts and components that, as a rule, were close to the assembly plants.

Table 3.2. Changes in vehicle production

	1990	2002	Change, %
The Czech Republic	216,360	460,200	112.70%
Hungary	9,003	137,900	1,431.71%
Poland	335,494	349,300	4.12%
Romania	101,400	84,400	-16.77%
Turkey	209,050	340,117	62.70%
Total	871,307	1,713,817	96.69%

Source: Trends and drivers of change in the European automotive industry: Mapping report, European Foundation for the Improvement of Living and Working Conditions, 2004

The problem of **re-locating production facilities**, especially the labor-intensive production of spare parts and components, outside EU borders to countries with low labor costs and potentially large domestic markets can be seen in the example of China, where such car-makers as Volkswagen, Peugeot – Citroën, BMW, and DaimlerChrysler set up joint ventures with local car-makers.

Ukraine–EU Action Plan progress in the transport sector¹⁷¹

What has been done:

- On 1 December 2005, a Cooperation Agreement on a Civilian Global Satellite Navigation System was signed.
- On 12 April 2006, a Program for National Network of International Transport Corridors Development in Ukraine for 2006–2010 was approved by Cabinet Resolution №496. Among other things, it anticipates bringing the level of building and servicing of domestic highways in line with EU standards.
- Ukraine participated on a regular basis in European Commission High-Level Group work on expanding the Trans-European Transport Networks to neighboring countries.
- On 7 September 2005, Ukraine acceded to a European agreement concerning the work of crews on vehicles involved in international car transport (Law №2819). The necessary amendments to regulate access to these professions were made to the Law "On motor transport" dated 23 February 2006.
- In 2005, a 224-km section of the M06 highway (Chop – Striy) and another roadway from this highway to the Ukrainian – Slovak border were put into operation, with EBRD funding. 169.1 km of roadway within the national network of international transport corridors was built or reconstructed and a further 198.1 km repaired.
- The European Conference of Ministers of Transport considered Ukraine's proposal to renew the "Silk Road" in a consolidated approach to develop efficient surface links between Europe and Asia.
- Carrying out a set of measures to ensure road safety made it possible to stabilize the accident rate on licensed automobiles in 2005. The number of accidents went down by 6%, number of fatalities by 6% and the number of traffic injuries by 2%.

¹⁷¹ Based on materials in a Ukrainian Government Position Paper, <http://www.kmu.gov.ua/document/41017941/укр%20версія%20Позиційний%20документ.doc>.

- On 28 February 2006, an agreement on a single set of conditions for regular technical check-ups and mutual recognition of these check-ups was approved by Presidential Decree №159. Fulfilling this agreement will promote environmental protection and greater traffic safety.
- On 11 July 2005, Ukraine acceded to a European Agreement on Key International Combined Transport Routes and Related Facilities via Presidential Decree №1077, to improve the effectiveness of combined freight traffic services, especially the border-crossing procedures.
- Acceding to a 3 June 1999 Protocol on amending the Convention concerning International Carriage by Rail (COTIF) via Law №3091 dated 16 November 2005 set the legal basis for allowing freight traffic to connect between Ukraine and EU countries using Ukraine's railway system.
- On 1 December 2005, a Ukraine – EU Agreement on certain aspects of sky links was signed. In order to improve bilateral agreements with EU members on air connections, talks were held on 1 May 2006 with Austria, Great Britain, Italy, Germany, Poland, Portugal, Hungary, France, and the Czech Republic. Draft protocols changing and amending existing agreements are being prepared.
- The insertion of the Joint Aviation Administration's Joint Aviation Requirements (JAR) in Ukrainian legislation continues. In 2005, the six JARs (JARFCL, JAR145, JAR66, JAR147, JAR21, JAROPS) minimally required for Ukraine's full membership to be considered by the JAA were introduced. State Aviation Service regional inspection stations were established for operative control over flight safety in the regions.
- Law №2881 of 7 July 2005 resolved the problematic issue of paying VAT for the temporary importing of aircraft to Ukraine's customs territory under operating leases.
- In February 2006, a technical workshop on bringing Ukrainian legislation in line with EU legislation on aviation transport was held in Brussels.
- Operational testing was launched at the Sevastopol Marine Rescue and Coordination Center of the Global Marine Communication System (with a range of over 90 nautical miles) in the Ukrainian search and rescue zone. A system of monitoring the water surface and a service for regulating vessel movement in the Ukrainian portion of the Danube were also introduced.
- In 2005, all commercial ports had premises for control services built, reconstructed and equipped based on the one-stop-shop principle, which made it possible to significantly optimize customs registration procedures.

- Participation in the Pan-European Transport Corridor №7 Steering Committee and in a Ministerial Conference under the aegis of the European Commission. As a result of this work, the decision was made to set up international working groups for rail, road and air transport, safety and ecology.
- On 27 – 28 February 2006, an International Conference called "Preservation and Sustainable Development in the Danube Delta" was organized in Odesa under the aegis of UNESCO and the International Commission for the Protection of the Danube River. Representatives of various international organizations, the EU and the Council of Europe took part in the conference. Conference results were collected in a document called "A Vision for Preservation and Sustainable Development in the Danube Delta."

What should be done:

- Draft a State Targeted Comprehensive Program for the Development of Ukraine's Transport Complex until 2015, and the Fundamentals [Strategy] of a Transport Policy.
- Acquire full membership in the Joint Aviation Administration (JAA) for Ukraine.
- Develop working procedures between the Ministry of Transport and Communication and the European Aviation Safety Agency (EASA) on maintaining aircraft flight-worthy.
- Sign an agreement on Ukraine's participation in the work of the European Marine Safety Agency and establish conditions for the exchange of information on marine safety issues between the sides.
- Bring into effect the Ukraine – EU Cooperation Agreement on a Civilian Global Satellite Navigation System.

Transport in Ukraine and the EU: Facts and figures

Table 5.1. Transport development statistics

Indicator	Ukraine (2004)	EU (2004)
Sector employment	0.73mn 1.5% of population	7.5mn 1.6% of the total population
Freight traffic, bn t*km	480.1 10,118 t*km/person	3,804 8,280 t*km/person
Traffic structure:		
Rail transport	49%	10%
Pipelines	42%	3%
Sea transport	2%	39%
River transport	1%	3%
Road transport	6%	45%
Passenger traffic, bn passenger*km	129 2,719 passenger*km/person	5,970 13,100 passenger*km/person [^]
Traffic structure:		
Road transport	37%	85%
Rail transport	40%	6%
Air transport	4%	8%
Tram+subway	19% (+trolleybus)	1%
Average growth rate, 1995–2004:		
Freight traffic	-1.4%	2.8%
Passenger traffic	0.8%	1.9% [^]
Traffic fatalities, per mn residents	147	95

Sources: Derzhkomstat, Eurostat. Notes: [^] 2003, [^] 1995–2003

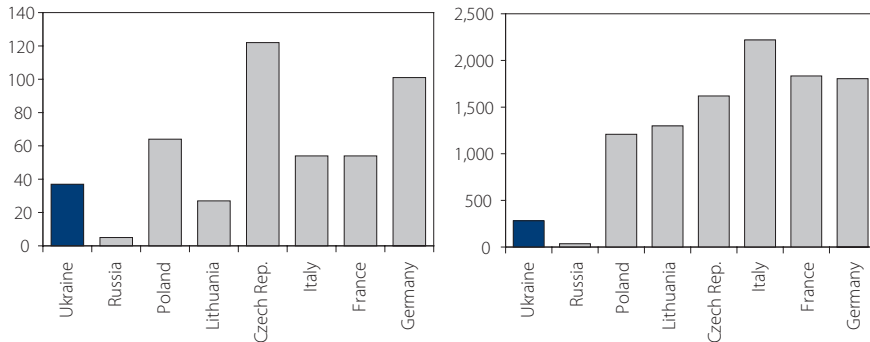
Ukraine's transport infrastructure, especially roads and railways, is less developed than that of European countries. This is especially true of the country's highway and road system (see **CHARTS 5.1** and **5.2**). Dispersed and low-quality transport links make it difficult to develop transit traffic through Ukraine. The structure of freight traffic is determined by Ukraine's trade peculiarities. Metals, ore, coking coal and grain constitute a major share of export by rail and water transport. The share of rail transport is considerable in both exports and imports.

Over the last 10 years, a structure of the country freight traffic has changed (see **CHART 5.4**). Traffic by water declined the most, whereas pipeline transport remained unchanged due to fairly steady growth rates in oil and gas transit through Ukraine's territory. From 2001 through 2005, the greatest rise was registered in rail and air transport.

Chart 5.1. Railway density

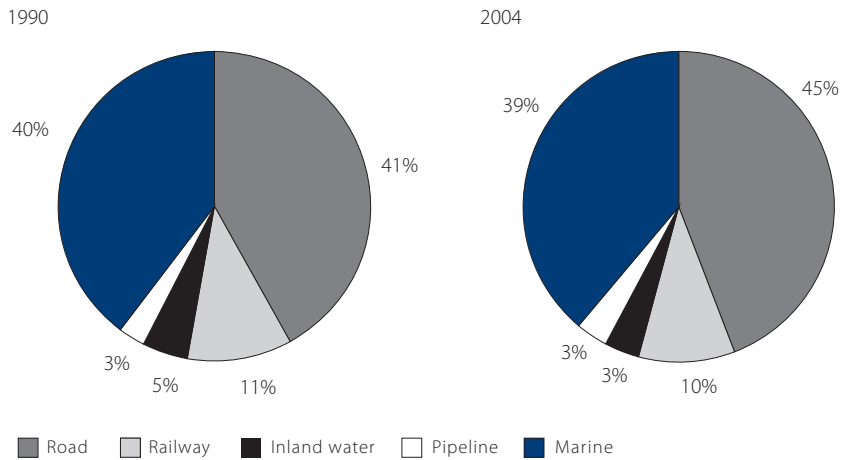
Chart 5.2. Highway density

m/km², data for 2003



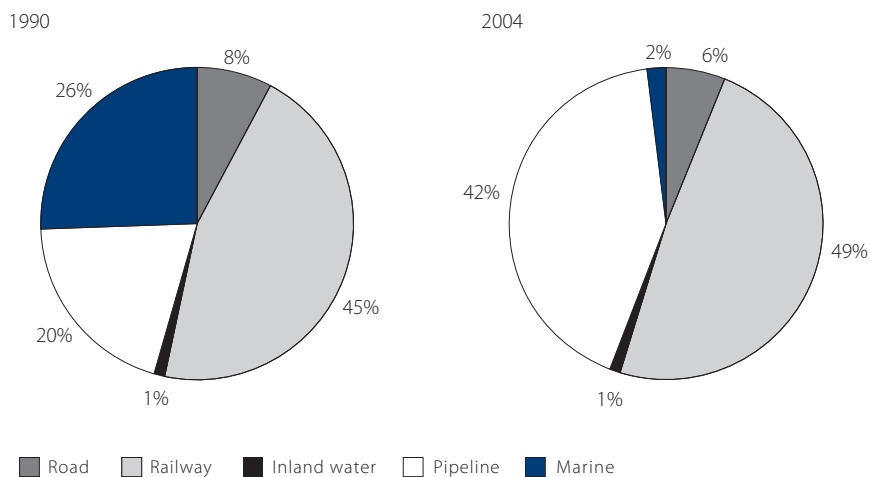
Sources: Eurostat, Derzhkomstat; calculations by ICPS

Chart 5.3. EU freight traffic structure by major modes of transport, 1990 and 2004



Source: Eurostat

Chart 5.4. Ukraine's freight traffic structure by major modes of transport, 1990 and 2004



Source: Eurostat

EU trade restrictions on Ukrainian steel

At the beginning of the 1990s, Ukraine and a number of other countries from the former Soviet Union became major exporters of metals. This led to a shock in the supply chain on international markets. In response, the EU instituted trade barriers against steel imports from Kazakhstan, Russia and Ukraine.

Quotas

Over 1996 – 2000, the EU set quotas for certain steel products from Ukraine, on average 250,000 t. This amounted to about 20% of all the tonnage Ukraine was exporting to the EU at that time. In 2001, Ukraine and the EU came to an agreement that saw the quota increased 35% to 355,000 t for 2002 – 2004, on condition that Ukraine removed all restrictions on the export of scrap steel to the EU. However, the EU never signed this agreement, arguing that Ukraine was slow in refunding the VAT to its exporters of scrap steel. When Ukraine instituted duty on such exports, the EU responded by reducing the quota for steel by 30% in 2003. With the expansion of the EU in 2004, however, the quota was gradually increased to nearly 1 million t.

Table 6.1. EU quotas on Ukrainian steel products, 2005

Category	Quota, mn t	Licensed volumes, mn t	Utilization of quota, %
Hot rolled coils (SA1)	150,000	122,984	81.99
Heavy plate (SA2)	348,000	339,846	97.66
Other flat-rolled products (SA3)	97,000	76,426	78.79
Beams (SB1)	30,000	27,772	92.57
Wire rod (SB2)	125,000	117,468	93.97
Other long products (SB3)	230,000	208,704	90.74
Total	893,197	893,197	91.14

Source: <http://sigl.cec.eu.int/querysteel.html>

Customs limitations

The EU has maintained its anti-dumping tax at 38 – 52% on a slew of Ukrainian steel products, like seamless and welded pipes, steel truss rods, and wire. At the same time, since Ukraine is not yet a member of the WTO—and for most

of the time that probes were under way, the country's economy was not even recognized as a market one—, domestic business has had a hard time to defend its position. Regular duty on imported steel products do little to restrict trade as they are on average about 2.6% on the EU side and 4% in Ukraine.

Table 6.2. EU anti-dumping probes against Ukraine

Type of product	Current measures	
	Delivery volumes, mn EUR	Anti-dumping tax
Seamless pipes	82.2 (2005)	12.3–25.7%
Steel truss rods and cables	2.9 (1998)	51.8%
Welded pipes	7.5 (2000)	30.9–44.1%

Source: Ministry of Economy

Current agreements

The expansion of the EU in 2004 had mixed consequences for Ukrainian exporters of steel. As a result of negotiations to soften the negative impact of the expansion, a number of anti-dumping probes were dropped and the quota on imported steel products to the EU-25 for 2004 was set at 606,800 t. This was not the kind of increase Ukrainian steelmakers had hoped for, because in 2003 Ukraine exported nearly 800,000 t of steel products just to the EU-10. On the other hand, import duty on steel was reduced from 10% in Poland, as an example, to 2.6% across the EU.

In March 2005, Ukraine and the EU agreed that the quota would be raised to 890,000 t and 1,004,500 t in 2005 and 2006. This agreement also establishes that the quota can be increased for Ukrainian companies that open new wholesale steel product trading centers in the EU. In 2006, the EU decided to allow Ukrainian companies to sell, in addition, the unused quota remaining from 2005. In 2007, quantitative restrictions on imports of steel products from Ukraine were left at 2006 levels.

How Central Europe restructured its steel industries

Prior to their accession to the EU, candidate countries were obligated to restructure their steel industry in order that their enterprises might be more competitive under the EU's strict competition, environmental and labor legislation. The EU did allow candidate countries to provide state aid to enterprises that, in their straitened financial state, would be unable to meet this objective on their own. Through its Structural Funds, the EU provided large-scale support to cope with the problem of unemployment and reducing the harmful impact on the environment. The main result of restructuring was a reduction in inefficient capacities, an improved bottom line, and the buyout of state-owned companies by strategic investors.

The success of CE countries in reorganizing their steel industries and integrating them into a common EU market was the result of a number of factors:

- 1) State aid was critical for coping with precisely those temporary problems that made it difficult for companies to be competitive. Resolving a difficult financial situation among state-owned enterprises, which found themselves drowning in an accumulation of debt during the 1990s, finally made it possible to attract strategic investors to the sector.
- 2) The requirement to cut back inefficient capacities made it possible to improve the state of manufacturers' fixed assets and to increase their competitiveness, while avoiding market distortions through an excess accumulation of production capacities.
- 3) The European Commission's strict oversight of the provision of assistance made possible targeted use of funding and the necessary reduction and renovation of capacities.

CE candidate countries and Ukraine had a number of similar structural problems in this sector: inefficient production equipment, low added value of production output, and both quality and product range that did not match customer needs. However, the restructuring mechanism is not entirely appropriate for Ukraine for two reasons:

- 1) Designating a fair level and form of assistance is a problem. It would make more sense to require manufacturers to cut back inefficient capacities and direct state aid at acquiring innovative, environment-friendly lines.

However, companies that have already been privatized and are in a viable financial position obviously should upgrade their production largely at their own cost, as their owners stand to gain the most from modernizing. By contrast, CE steel industries were mostly in state hands at the time structural assistance was being provided.

This means that relatively modest amounts of assistance would be acceptable in the form of loans, mostly for environmental purposes and R&D. Yet, the importance of the steel industry to Ukraine's overall economy is far higher than was the case with Central European countries. So even small amounts of assistance to this huge industry could prove a major burden to the State Budget.

- 2) There is a serious risk that funds designated for state aid will be applied unfairly and not for the intended purpose because of Ukraine's weak court system and the close ties between the Government and business.

Energy agreements with the EU

Partnership and Cooperation Agreement

Cooperation takes place following market economy principles and the European Energy Charter based on a gradual unification of energy markets in Europe. The Document agrees the actions of Ukraine and the EU for 1997 – 2007 in these areas:

1. Avoiding or minimizing damaging environmental impact from producing and consuming energy.
2. Increasing the quality and security of energy supplies, including diversifying suppliers.
3. Developing an energy policy.
4. Improving the management and regulation of the energy sector in response with the needs of a market economy.
5. Establishing the range of institutional, legal, financial and other conditions necessary to encourage expanded trade and investment in energy.
6. Fostering energy conservation and efficiency.
7. Modernizing, expanding and diversifying energy infrastructure.
8. Improving energy-saving technologies and the end-use of all forms of energy.
9. Management and technical training in the energy sector.

Ukraine–EU Action Plan

In this agreement, signed within the framework of the EU's European Neighborhood Policy, energy is recognized as one of the priority areas of cooperation. Among others, it establishes the goal of gradual transition to the principles on which the EU's internal gas and electricity markets function. This is a basic condition for integrating electricity market into the EU's internal energy market. This objective can be reached provided that certain steps are taken:

1. Identifying a list of measures that will enable a gradual switch to the principles along which the EU's internal gas and electricity markets function. This includes such issues as regulatory bodies, schedules and a financial plan.
2. Appropriately resolving those issues that are of common interest: access to markets, environmental standards, and international recognition of nuclear safety standards.
3. Establishing a pricing policy for converging the Ukraine and EU markets.
4. Adopting and instituting a Law on the NERC.

5. Further reorganizing the energy sector, including restructuring debts and approving the necessary law on debts.
6. Participating in related EU measures in the power sector, including gradual involvement in European regulatory forums on gas and electricity.

Energy MoU between Ukraine and the EU¹⁷²

Both sides outlined an Action Plan regarding the integration of energy markets. Carrying out these plans requires the introduction of key elements of the *acquis communautaire* in terms of energy, the environment, competition and renewable energy sources. Establishing equal conditions for the basic rules of market access, access to infrastructure and the opening of the market, as well as combined standards for environmental protection and safety should foster trade in electricity between Ukraine and the EU.

With EU technical assistance, Ukraine will be able to harmonize its legislation with the relevant rules in the Energy Community. In order to gradually switch from the current market structure to an open market, Ukraine will have to work in a number of areas:

1. Reforming electricity rates.
2. Developing ways to ease the impact of reforms on vulnerable social groups.
3. Cutting line losses.
4. Increasing the energy efficiency to reduce relative demand.
5. Ensuring that power utilities (suppliers) are fully paid.
6. Diversifying supply sources, including changing traditional energy sources for renewable ones, while maintaining the foundations of a free market.
7. Optimizing the structure of energy use in power generation to increase efficiency, environmental protection, reliability, and security of supplies.

The MoU also notes that EU member countries are positive about Ukraine's goal of synchronizing its grids with UCTE and they intend to support the country in this.

Energy Community Treaty between the EU and eight countries in Southeastern Europe

On 25 October 2005, Ukraine became an observer to the European Energy Community, an international organization that coordinates policy in the

¹⁷² The Memorandum of Understanding between Ukraine and the EU regarding cooperation in the electricity sector was signed by the President of Ukraine on 1 December 2005.

trade of electricity and fuels. The Energy Community Treaty between the EU and Southeastern European countries¹⁷³ presents a series of measures for the gradual integration of the region into the EU energy market over the course of 10 years.

Participating countries are expected to: carry out reforms in rate regulation for both electricity and gas; introduce technical standards, such as coding systems, regulation, automation, telecommunication, and energy system monitoring; ensuring effective access to infrastructure for third parties; establish transmission system operators and national energy regulators; and introduce the EU energy Directives.

Within the context of this Treaty, Ukraine has committed itself to start radical reforms in the fuel and energy sector. These requirements include upholding anti-monopoly standards in the export of energy supplies, canceling restrictions on electricity exports and fulfilling a number of commitments to carry out EU environmental directives.

¹⁷³ Former Yugoslavia, Albania, Bulgaria and Romania.

Trends in energy trading between Ukraine and the EU

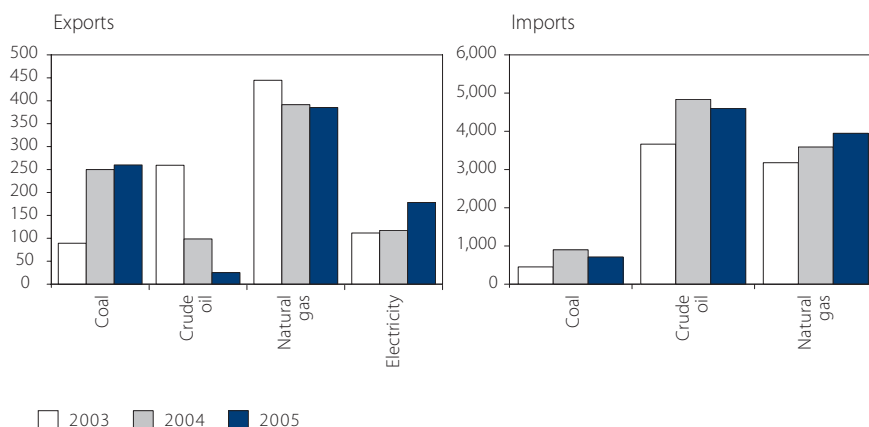
Trade in energy resources is fundamentally important for Ukraine. Throughout 2002 – 2005, energy took second place after steel in the structure of Ukraine's exports, while the item "Energy materials, petroleum and processed petroleum products" was in first place among imports over 2002 – 2004.

Over 2003 – 2005, the structure of energy exports changed significantly. The export share of electricity and hard coal in the total volumes continued to grow, while petroleum shrank. In 2003, the largest share of export belonged to natural gas (49%) and crude oil (29%), while the shares of electricity and hard coal was only 12% and 10%. By 2005, the share of natural gas remained high (46%), while electricity and coal grew to 21% and 31% and crude oil collapsed to 3%.

Petroleum and petroleum products play a major role in the structure of energy trade between Ukraine and the EU-25, both in exports and in imports, whereas gas, coal and electricity are mostly exported by Ukraine. Still, the place of resins, lubricants and pitch continues to grow in energy trading.

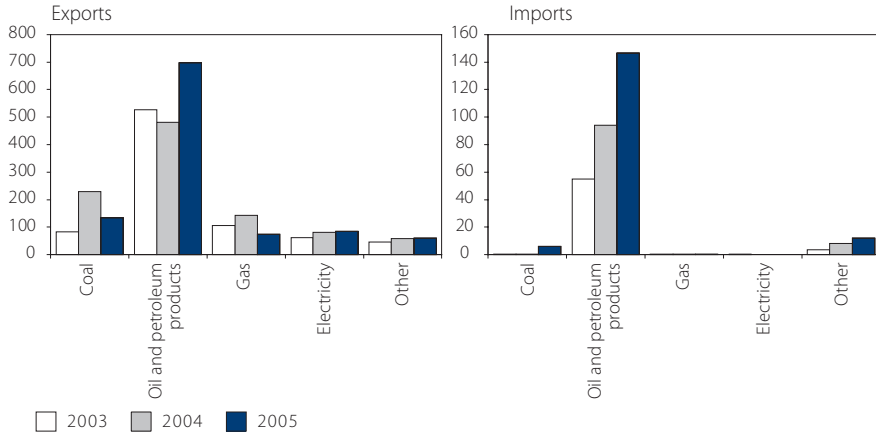
Ukraine always exported more fuels and petroleum products to the EU-15, while importing more energy from the EU-10, with the exception of 2003.

Figure 9.1. Ukraine's energy import and export dynamics, '000 USD



Source: Derzhkomstat

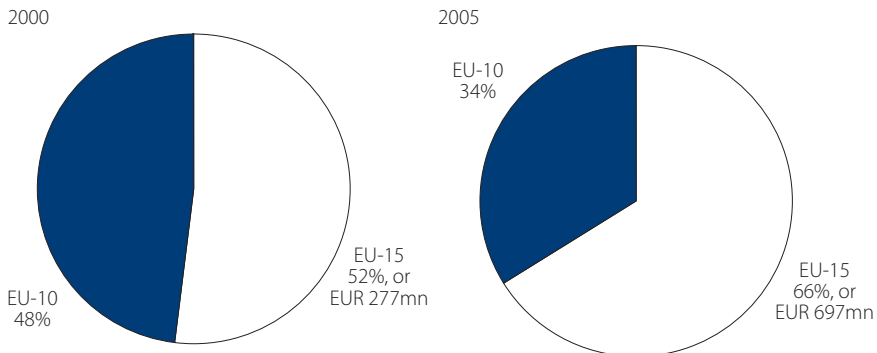
Figure 9.2. Energy trade with the EU-25, '000 EUR



Source: Eurostat

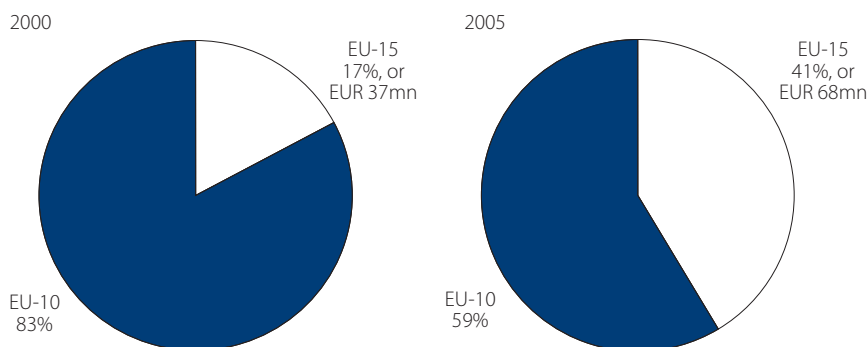
Among the EU-15, Italy, Great Britain and Germany traditionally imported the most energy from Ukraine, while Germany, Finland and Belgium exported the most. In 2003, volumes of energy traded between Ukraine and the EU-15 fluctuated between steep growth, to US \$1.24bn in 2003, and steep decline, to US \$0.95bn in 2004. Trade volumes with EU-10 countries have been growing steadily. In 2002, turnover was US \$0.47bn, while in 2004 it nearly doubled, to US \$0.78bn. The largest portion of Ukrainian energy exports to new EU members goes to Poland, Cyprus and Latvia. Electricity plays a major role in energy trade between Ukraine and the EU. Ukraine has enormous potential to export electricity and volumes have been growing sharply every year. In general, Ukraine exports power to Central European countries that are already EU members (Poland, Romania, Slovakia and Hungary) and to CIS countries (Moldova and Russia).

Figure 9.3. The structure of Ukraine's energy exports to the EU



Source: www.exporthelp.europa.eu

Figure 9.4. The structure of EU energy imports to Ukraine



Source: www.exporthelp.europa.eu

Table 9.1. Energy trade among EU countries, 2002–2004, mn USD

Ukraine's trading partners	2002		2003		2004	
	export	import	export	import	export	import
EU-15	653	34	1,012	224	906	44
EU-10	367	100	659	76	693	87
EU-25	1,020	134	1,671	300	1,598	131

Source: Derzhkomstat

Electricity plays a major role in energy trade between Ukraine and the EU. Ukraine has enormous potential to export electricity and volumes have been growing sharply every year. In general, Ukraine exports power to Central European countries that are already EU members (Poland, Romania, Slovakia and Hungary) and to CIS countries (Moldova and Russia).

Table 9.2. Ukraine's energy exports, 2003–2006, bn kWh¹⁷⁴

Countries	2003	2004	2005	10M'06
EU, including:	4.28	4.18	4.60	4.12
Hungary	3.17	2.96	3.32	2.93
Poland	0.93	0.85	0.98	0.76
Slovakia	0.18	0.37	0.30	0.43
Others, including:	0.88	1.17	3.76	4.17
Russia	0	0.25	2.83	0
Moldova	0.88	0.92	0.80	2.01
Romania ¹⁷⁴	0	0	0.13	0.04
Belarus	0	0	0	2.12
Total	5.16	5.35	8.36	8.29

Source: Ministry of Fuel and Energy

¹⁷⁴ EU Member State since 1 January 2007.

State aid: Facts and figures

Table 10.1. Potentially distorting tax breaks in Ukraine,¹⁷⁵ UAH mn

	2002	2003	2004	2005
Processing baby food	—	38	26	33
Publishing	488	559	279	434
Steel industry	492	0	0	0
Car-making	296	1,186	1,897	695
Aircraft building	54	46	22	19
Shipbuilding	43	33	42	14
Aerospace	36	60	94	5
Armored vehicles	28	23	18	17
SEZs and TPDs	357	415	568	7
Technoparks	44	36	144	11
Fuel & electricity complex (FEC)	522	4,763	4,195	5,748
Deposit exploration	29	75	95	79
Agriculture	573	577	256	1
Pharmaceuticals	3,113	3,216	1,163	1,454
Total	6,075	11,025	8,799	8,517

Source: Ministry of Finance; calculations by ICPS

Table 10.2. State aid in FTAs between the EU and its trading partners¹⁷⁶

FTA	MED1	MED2	MED3	TDCA	Mexico	Chile
This issue covered	—	Yes	Yes	Yes	—	Yes
Transparency	—	Yes	Yes	Yes	—	Yes
Regular monitoring by Cooperation Council	—	—	—	Yes	—	—
Annual report on extent of assistance	—	Yes	Yes	—	—	Yes
Reference to EU law on state aid	—	—	Yes	—	—	—

Source: S. Szepesi, *Comparing EU FTAs: Competition Policy and State Aid*. (ECDPM InBrief 6E). Maastricht: ECDPM

¹⁷⁵ In the extensive list of taxes and fees that enterprises can be absolved from paying, the main ones are corporate profit tax, the VAT, and the land tax. A full list of tax exemptions would include relief from paying: taxes on owned vehicles and other independent transport machines and mechanisms, for special use of water resources, and for the use of underground resources; fees for geological exploratory works at Budget expense; excise duty on domestic or imported goods; local taxes and fees; customs duty; and environmental penalties.

¹⁷⁶ MED1: Agreement with Algeria and Lebanon; MED2: Agreement with Israel; MED3: Agreement with Jordan, Morocco, the Palestinian Authority, and Tunisia; TDCA: Agreement with the South African Republic.

Table 10.3. State aid in select European countries over 2002–2004¹⁷⁷

	State aid, EUR mn	Population, mn	State aid, EUR/person**
EU-25	48,991	450,6	109
EU-15	42,717	376,5	109
Non-Members*	6,274	14,1	161
Bulgaria	65	7,8	23
Romania	981	21,7	118
The Czech Republic	1,826	10,2	336
Estonia	9	1,4	11
Cyprus	231	0,7	368
Latvia	15	2,3	13
Lithuania	43	3,4	26
Hungary	808	10,1	136
Malta	139	0,4	514
Poland	2,902	38,2	158
Slovenia	135	2,0	92
Slovakia	167	5,4	59

Source: Eurostat

Table 10.4. EU state aid as % GDP

		2000	2001	2002	2003	2004
EU-15	State aid	0.6	0.6	0.7	0.6	0.6
	not including agriculture	0.4	0.4	0.5	0.4	0.4
New EU members	State aid	1.2	1.0	1.2	2.1	1.1
	not including agriculture	1.2	1.0	1.2	2.1	0.7

Source: Eurostat

¹⁷⁷ Not including aid to farmers, the fishing industry and transport.
* new EU members; ** based on Purchasing Power Parity (PPP).

The multilateral GPA under the WTO¹⁷⁸

Although the principle “best value for the money” can only be maintained using an open and non-discriminating approach, governments sometimes try to reach certain domestic policy goals through discriminatory ways of arranging government procurements. Among this kind of goals is encouraging industrially backward regions or sectors of the economy.

Such measures can be directly prescribed in domestic legislation, such as prohibitions against foreign goods or services and bans on buying from foreign suppliers. Or they can take the form of preferential price caps, preference margins or set-asides for certain groups of manufacturers. Preferential treatment can also come in the form of less obvious measures or practices that effectively eliminate any opportunities for foreign products, services and suppliers to compete on the domestic procurements market. These include the excessive use of single and selective tendering, opaque technical specification requirements, and especially untransparent tendering procedures, including contract awards. This kind of discriminatory procedures and practices can easily distort international trade.

The desire to resolve current problems arising from discriminatory government procurement policies led to the first efforts to establish internationally agreed rules of trading during the Tokyo round of trade talks. The result of this push was the signing of a multilateral Government Procurement Agreement in 1979.¹⁷⁹

According to the GPA signed in Marrakech, the new rules of government procurement cover both goods and services and extend their effect beyond government procurements agencies of the highest level to include community enterprises.

Main features

The GPA establishes an agreed list of rights and obligations among the parties based on their national legislation, procedures and practices in government procurement. The main point of the agreement is non-discrimination between

¹⁷⁸ This text is based on a WTO document entitled “Overview of the Agreement on Government Procurement.” See http://www.wto.org/english/tratop_e/gproc_e/over_e.htm.

¹⁷⁹ The GPA was amended in 1987. The 1994 GPA was signed in Marrakech on 15 April of that year, along with the agreement establishing the World Trade Organization. The new GPA came into force on 1 January 1996 and is one of the multilateral documents that were in Appendix 4 of the agreement establishing the WTO.

the products, services and suppliers of the countries that have joined the Agreement, domestic manufacturers and distributors. To enforce the basic principle of non-discrimination, the agreement emphasizes the importance of ensuring transparency in domestic legislation, procedures and practices involving government procurements.

Scope and coverage

The GPA does not apply to all government procurement organizations. The commitments in the Agreement apply to tenders that have specific features:

- they involve purchasing organizations that have been specified by each party to the Agreement (central agencies, lower-level agencies, community enterprises, and so on, based on the parties' lists);
- state purchases of goods and construction and other services as designated in the Agreement;
- contracts for state purchases above a certain threshold value. Each party designates the minimum amount involving procurements of goods and services. The Agreement allows the parties to mutually agree changes to its coverage. From the moment it was signed in April 1994, the Agreement has been expanded through the inclusion of the results of a series of bilateral agreements between individual parties.

To determine directly whether a given government procurement contract is covered by the Agreement, compliance should not only be checked in terms of the criteria designated in the Addendum but also in the General Notes provided at the end, where the parties list all exceptions. Exceptions to the Agreement are also permitted to developing countries in certain situations, as well as for non-economic reasons, such as to protect national security, public morals, order, the lives of humans, animals and plants, intellectual property, and so on. The Agreement requires that notices of invitation to a tender include information about whether or not tender contracts for that particular procurement are governed by the GPA.

Tendering procedures

The GPA includes a detailed description of procedural requirements that need to be complied with by the purchasing organization in order to effectively apply its basic principles. The goal of these procedural requirements is to guarantee equal access to procurements that fall under the Agreement to foreign deliveries and suppliers in the competition for procurement contracts.

The Agreement allows the use of open, selective and limited tendering procedures, on condition that they consistent with its provisions. To ensure effective

international competition, purchasing agencies are obligated to maximally include foreign suppliers in their tenders.

Participation in tenders may be limited only in the most critical criteria necessary to confirm the capacity of bidders to actually carry out the contract, but these conditions should not be of a discriminatory nature. Once a year, the organizations that use the selective tendering method are expected to publish in a publication designated in the Agreement, their lists of qualified suppliers, to indicate the term of effect of such lists, and to specify the conditions that interested suppliers must meet in order to be included on them. The Agreement circumscribes the situations in which the limited tendering method may be used, such as in the absence of bidders in response to an open or selective tender, or in cases of collusion, where the good or service can only be provided by a specific supplier, or when there is an extremely urgent need due to unforeseen circumstances.

Organizations may negotiate with suppliers who have offered propositions only on condition that this format is stated explicitly in the first tender announcement or an evaluation of the tender reveals that none of the propositions is more convenient. This kind of negotiations should not discriminate among suppliers.

The Agreement anticipates specific deadlines that should be provided for preparing, submitting and receiving propositions. These should be long enough for all suppliers, both domestic and foreign, to be able to prepare and submit proposals before the closing of the tendering procedure. As a rule, this is a minimum of 40 days from the date the call to tender was published. This minimum amount of time for receiving tender proposals can be reduced to 25 days, or even 10, under very clearly defined circumstances.

In the tender documentation, the purchasing agency must indicate all the necessary information required for procurements to allow potential suppliers to prepare a suitable proposition, including information that is supposed to be published in calls to tender and other important information such as economic and technical specifications, financial guarantees, criteria for awarding the contract, as well as procedural information such as the closing date and time for receiving proposals. The purpose of procedural rules for submission, reception and opening of tenders is to ensure equality and transparency in the procurement process.

Purchasing agencies are obligated to award contracts to suppliers who have been judged capable of fulfilling the contract and have offered either the lowest price or the most advantageous proposal based on review criteria established in the tender notice or tender documentation. An agency that has received a proposal with an exceptionally low price may question the supplier as to its compliance with the conditions of participation and its capacity to carry out all the terms of the contract.

Other provisions for open procurement

The GPA explicitly prohibits the use of offsets, that is, measures to stimulate local development, or to improve the balance of payments through local content, by licensing technologies, investment or other special requirements. Nevertheless, developing countries may, during their accession process, negotiate conditions to allow offsets if the latter will be used only as conditions for participating in the procurement process and not as criteria for awarding contracts.

The Agreement includes requirements as to technical specifications in order to avoid discrimination against or among foreign goods and suppliers through the designated technical characteristics of goods and services. Technical specifications should more describe features as a template and be based on international standards, where such exist, or, if not, on domestic technical norms, recognized national standards or building codes.

Prior notification

Prior to holding a tender, the agency must publish an invitation to participate in the form of a call to tender in publicly accessible publications, in accordance with the appendix of the GPA. The purpose of publication is to inform all interested suppliers about the upcoming procurement and the relevant requirements.

Post-award notification and publication

After the contract has been awarded, the GPA requires the purchasing agency to announce its decision in the form of a notice that includes such information as the nature and quantity of goods and services contracted for, the name and address of the winner of the tender, the value of the awarded contract or the largest and smallest bids that were taken into account during the awarding process.

In response to queries from the supplier, the purchasing agency should immediately provide the necessary information as regards:

- procurement practices;
- an explanation of the reasons why a supplier's application to qualify was rejected;
- the features and advantages of the chosen bid.

At the same time, purchasing agencies may withhold certain information on grounds of confidentiality. The Agreement allows for confidential information to be protected.

There is a general requirement to publish laws, court decisions, administrative rulings of general application and any procedures for government procurements covered by the Agreement. According to the GPA, every Government must collect and provide statistics on those of its procurements covered by the Agreement for other parties to the GPA.

Special rules for developing countries

The GPA recognizes the development, financial and trade needs of developing countries, especially least-developed countries. According to this principle, the Agreement allows special and differentiated approaches to meet specific development goals for this category of countries who are Party to the GPA. The development objectives of developing countries should be taken into account in the process of negotiating the coverage of procurements by agencies in developed and developing countries. The Agreement also includes provisions regarding: technical assistance, establishing centers to provide information about procurement practices and procedures in developed countries, and special treatment for least developed countries.

Enforcement

The GPA requires a functional domestic bid challenge system, providing suppliers who believe that the procurement process has not met GPA requirements the right to appeal to an independent domestic tribunal. GPA Parties may authorize national courts or another impartial and independent body the right to review such challenges. At the time of appeal, the reviewing body should have the power to apply immediate temporary measures, including a suspension of the procurement process, to correct breaches of the Agreement.

Regulating labor migration and business operations in various EU agreements

	European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
Countries	Central-European candidate countries	Current and potential West Balkan candidates: Albania, Bosnia and Herzegovina, Macedonia, Serbia, Montenegro, Croatia.	Barcelona Process countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria, and Tunisia.	CIS countries and Mongolia
Location in the agreement	Based on an Agreement with Poland signed in 1991 that came into force in 1994. "Movement of workers, establishment, supply of services;" chapters on "Movement of workers" and "Establishment"	Based on an Agreement with Albania signed in 2006 that is in the process of ratification. "Movement of workers, establishment, supply of services, current payments and movement of capital;" chapters "Movement of workers" and "Establishment"	Based on an Agreement with Algeria signed in 2002 that is in the process of ratification. "Social and cultural cooperation;" chapter on "Workers" "Trade in services;" articles regulating commercial presence and temporary presence of natural persons	An agreement with Ukraine signed in 1994 that came into force in 1998 "Provisions affecting business and investment;" chapters on "Labor conditions" and "Conditions affecting the establishment and operation of companies"
Norms regulating the movement of workers	Applies to legal workers and members of their families (spouse and children) 1. Subject to the conditions and modalities applicable in each Member State: 1) the treatment of Polish workers legally employed on the territory of a Member State shall be free from any discrimination based on nationality, as regards working conditions, remuneration or dismissal, relative to its own nationals;	Non-discrimination principle (national treatment) Applies to legal workers and members of their families (spouse and children) Following the same text as in a European Agreement on Association with EU Member States	Applies to legal workers	Applies to legal workers Subject to the laws, conditions and procedures applicable in each Member State, the Community and the Member States shall endeavor to ensure that the treatment accorded to Ukrainian nationals legally employed on the territory of a Member State shall be free of discrimination based on nationality.

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European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
<p>2) the spouse and children of a worker legally employed on the territory of a Member State, with the exception of seasonal workers and workers under bilateral agreements within the meaning of Art. 41, unless otherwise provided by such agreements, shall have access to the labour market of that Member State, during the period of that worker's authorized stay of employment.</p>	<p>2. Algeria shall accord the same treatment to workers who are nationals of a Member State employed on its territory.</p>	<p>Subject to the laws, conditions and procedures applicable in Ukraine, Ukraine shall endeavor to ensure that the treatment accorded to nationals of a Member State, legally employed on the territory of Ukraine shall be free of discrimination based on nationality, as regards working conditions, remuneration or dismissal, relative to its own nationals</p>	<p>as regards working conditions, remuneration or dismissal, relative to its own nationals.</p> <p>Subject to the laws, conditions and procedures applicable in Ukraine, Ukraine shall endeavor to ensure that the treatment accorded to nationals of a Member State, legally employed on the territory of Ukraine shall be free of discrimination based on nationality, as regards working conditions, remuneration or dismissal, relative to its own nationals</p>
<p>Social security systems coordination</p>			
<p>Applies to legal workers and members of their families</p>	<p>Applies to legal workers and members of their families</p>	<p>Applies to legal workers and members of their families</p>	<p>Applies to legal workers</p>
<p>For workers of Polish nationality legally employed on the territory of a Member State and for the members of their family legally resident there and subject to the conditions and modalities applicable in each Member State:</p>	<p>Following the same text as in a European Agreement on Association with the Central European States</p>	<p>Workers of Algerian nationality and any members of their families living with them shall enjoy, in social security, treatment free of discrimination based on nationality relative to nationals of the Member States in which they are employed.</p>	<p>Following the same text as in a European Agreement on Association with the Central European States, albeit without Point 3 on payments to family members.</p> <p>Ukraine applies regulations enclosed in Point 2 to workers from the EU.</p>

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European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
<p>1. all periods of insurance, employment or residence completed by such workers in the various Member States shall be added together for the purpose of pensions and annuities in respect of old age, disability and death and for the purpose of medical care for such workers and such family members;</p> <p>2. any pensions or annuities in respect of old age, death, on-the-job accident or occupational disease, or of disability arising therefrom, with the exception of non-contributory benefits, shall be freely transferable at the rate applied by the law of the debtor Member State or States;</p> <p>3. the workers in question shall receive family allowances for the members of their family as defined above.</p> <p>Poland shall accord to workers who are nationals of a Member State and legally employed in its territory, and to members of their families legally resident there, treatment similar to that specified in the second and third Points.</p>	<p>Following the same text as in a European Agreement on Association with the Central European States. However, the social security list is broader than that in similar agreements.</p> <p>The term "social security" shall cover the areas of social security dealing with sickness and maternity benefits, disability, old age and survivors' benefits, on-the-job accident and occupational disease benefits and death, unemployment and family benefits.</p> <p>Algeria takes on the same obligations as those stipulated for candidate states.</p>		

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European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
<p>Application of bilateral agreements</p> <p>If the bilateral agreements with the Member States provide for more favorable treatment of nationals of Poland (Albania) on the market, the norms in the bilateral agreements shall continue to be applied and, where possible, interpreted broadly. The other Member States shall consider favorably the possibility of concluding similar agreements.</p>	<p>More favorable treatment</p> <p>If bilateral agreements with the Member States provide for more favorable treatment of nationals of Ukraine (Algeria) or of the Member States, the regulations in the bilateral agreements shall be applied, and not the regulations of a Free Trade Agreement.</p>	<p>More favorable treatment</p> <p>If bilateral agreements with the Member States provide for more favorable treatment of nationals of Ukraine (Algeria) or of the Member States, the regulations in the bilateral agreements shall be applied, and not the regulations of a Free Trade Agreement.</p>	
Natural and legal persons	Natural and legal persons	Legal persons	Legal persons

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Norms regulating establishment and operations of companies

European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
<p>Agreement Appendices specify transition periods for certain sectors and for the right of both natural persons and subsidiaries to buy and sell real estate and lease farmland, timberland and natural resources.</p> <p>The "Stand still" principle applies for the transition period.</p>	<p>2) subsidiaries and branches of Community companies in Albania no less favorable than that accorded to its own companies or to any third country company, whichever is better</p> <p>A five-year transition period for natural persons who are EU or Albania nationals. The "Stand still" principle applies for the transition period.</p>	<p>2) Algeria shall grant to subsidiaries and branches of Community companies treatment no less favorable than that accorded to its own or any third country companies or branches, whichever is better.</p>	<p>2) subsidiaries or branches of Community companies treatment no less favorable than that accorded to its own companies or branches or to companies or branches of any third country, whichever is better</p>
Key personnel			
<p>The right of third country or Community companies, their subsidiaries and branches, in conformity with the right to employ workers and officers who are citizens of this country or Community Member States, on condition that these employees are key personnel and are hired exclusively by such companies, subsidiaries or branches. Residential and work permits for such employees shall only cover the period of such employment.</p>			
<p>Applies to enterprises established by natural and legal persons</p> <p>Key personnel of the beneficiaries of the rights of establishment ("organization") are:</p> <p>a) senior employees of an organization who primarily direct the management of the organization, receiving general supervision or direction principally from the board of directors or shareholders of the business, including:</p> <ul style="list-style-type: none"> - directing the organization or a department or sub-division of the organization, - supervising and controlling the work of other supervisory, professional or managerial employees, 	<p>Applies to legal persons</p> <p>Key personnel of such companies, ("organizations"), are "intra-corporate transferees" as defined in Point (c) of the categories below, provided that the organization is a legal person and that the persons concerned have been employed by it or have been partners in it (other than as majority shareholders), for at least the year immediately preceding such movement:</p> <p>a) persons working in a senior position with an organization, who primarily direct the management of the establishment, receiving general supervision or direction principally from the board of directors or stockholders of the business or their equivalent including:</p>	<p>Applies to legal persons</p> <p>Following the same text as in the Agreement on stabilization and association with the West Balkan States</p>	<p>Applies to legal persons</p> <p>Following the same text as in an Agreement on stabilization and association with the West Balkan States. However, there are no provisions regulating the departure and temporary presence of a company representative for the purpose of establishing a subsidiary company or branch.</p>

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European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
<ul style="list-style-type: none"> - having the authority personally to engage and dismiss or recommend engaging, dismissing or other personnel actions; 	<ul style="list-style-type: none"> - directing the establishment or a department or sub-division of the establishment; - supervising and controlling the work of other supervisory, professional or managerial employees; - having the authority personally to recruit and dismiss or recommend recruiting, dismissing or other personnel actions; 		
<p>b) persons employed by an organization who possess high or uncommon, qualifications referring to a type of work or trade requiring specific technical knowledge, knowledge essential to the organization's service, research equipment, techniques or management. These may include, but are not limited to, members of accredited professions. Each such employee must have been employed by the organization concerned for at least one year preceding the detachment by the organization.</p>	<p>b) persons working within an organization who possess uncommon knowledge essential to the establishment's service, research equipment, techniques or management. The assessment of such knowledge may reflect, apart from knowledge specific to the establishment, a high level of qualification referring to a type of work or trade requiring specific technical knowledge, including membership of an accredited profession;</p>		
			<p>c) intra-corporative transferee is defined as a natural person working within an organization on the territory of a Party, and being temporarily transferred in the context of pursuit of economic activities on the territory of the other Party;</p>

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European agreements on association	Stabilization and association agreements	Euro-Mediterranean agreements on association	Partnership and co-operation agreements
	<p>the organization concerned must have its principal place of business on the territory of a Party and the transfer be to an establishment (branch, subsidiary) of that organization, effectively pursuing like economic activities on the territory of the other Party.</p> <p>The entry into and the temporary presence within the territory of the Community or Albania of nationals of Albania or Community nationals shall be permitted, when these representatives of companies are persons working in a senior position, as defined in Point (a) above, within a company, and are responsible for the setting up of a Community subsidiary or branch of a company from Albania or of a subsidiary or branch of a Community company in a Community Member State or in Albania, when:</p> <ul style="list-style-type: none"> – those representatives are not engaged in making direct sales or supplying services, and – the company has its principal place of business outside the Community or Albania, and has no other representative, office, branch or subsidiary in that Community Member State or Albania. 		

Environmental issues in EU trade agreements

To underpin gradual growth on a global scale, the European Union uses a number of measures to ensure that provisions to protect the environment form part and parcel of its external relations and trade policy. The EU places particular emphasis on the need to include the subject of the environment in the expansion process, on close global cooperation in environmental issues through the UN system, and on the search for a dynamic balance between liberalized trade and multilateral agreements to protect the environment.

Based on best practice in trade relations, current EU agreements with trade partners include provisions on sustainable development and environmental protection. At the same time the content of environmental articles is determined by the format of the given agreement and the prospects for developing bilateral relations on that basis.

Among others, when the EU signs bilateral cooperation agreements with third countries that have no ambitions of joining the Union and are geographically distant from it, such as its "global agreements" with Mexico and its Association Agreement with Chile, sustainable growth is nevertheless declared as a mandatory priority of cooperation and the environmental component is detailed in special articles. These agreements enshrine the concept that environmental protection and the environmental balance must be taken into account when carrying out any cooperation measures within the context of these agreements without any specific, detailed procedures for including the environmental component in trade operations. The purpose of measures specifically aimed at cooperation in the environment should cover environmental protection, protection against the pollution and degradation of natural resources and ecosystems, and rational utilization of the latter in the interests of environmental development.

Provisions on environmental cooperation in bilateral agreements signed as part of the Barcelona Process between the EU and immediate neighbor countries in the Mediterranean region, known as the EuroMED zone, place particular emphasis on promoting and executing regional environmental projects on a bi- and multilateral basis. This kind of format is expected to be used when environmental provisions are carried over to the EuroMED FTA.

Ecological issues were most thoroughly worked out in the series of agreements on European association that was signed between the EU-15 and the new members at the initial stage of expanding the EU to 25 countries. Among

others, the texts of these agreements set the objective of combating degradation of the environment as a priority and clearly formulate the principles for environmental cooperation. These are to be carried out through:

- the exchange of information and experts, including technology transfers;
- joint educational and training programs;
- harmonizing legislation on the basis on the EU *acquis*;
- cooperation at the regional, including EEA, and international levels;
- developing common strategies, especially as regards global climate change.

In this way, the issue of environmental cooperation is given a more grounded formulation based on how closely the partner country lies to the EU. The details of principles and areas of joint efforts depend directly on the form of cooperation between the Union and the third country: economic and regional cooperation or integrational movement with the prospects of membership.

As a component of the process of deepening cooperation between Ukraine and the EU, the FTA+ anticipates formulating a new model of joint work, closer to European association. On the other hand, Ukraine will remain a member of the CIS, which unequivocally places environmental projects at the level of "regional cooperation" based on multilateral agreements. Under these circumstances, the content of environmental articles in the FTA+ that will undoubtedly be included in its text will likely be based on political compromises, which will not properly reflect the intentions of the two sides in the environmental sphere.

A realistic assessment of the pros and cons of this kind of compromise can be made in the process of a Sustainable Impact Assessment or SIA, a relatively new system of preliminary research that is carried out in the process of trade negotiations with the EU. The SIA has been in use since 1999 for all EU trade relations in multilateral (the WTO rounds), regional (EU – MERCOSUR, EU – MEDA) and bilateral formats.

The research methodology involves a comprehensive, independent assessment of the impact on the social, economic and environmental stability of the development of trading partners in the process of preparing for and signing trade agreements, as well as a consultation process and open dialog with stakeholders from both sides.

The result of the research is a special report by the expert group about the impact of liberalized trade relations on attaining sustainable development in partner countries. It combines sectoral, territorial and generalized analysis of possible threats and opportunities from signing the agreement. At this time, the European Commission is preparing for this process with Ukraine and the necessary working group is being formed. Ukraine must prepare for effective cooperation for this assessment to be carried out successfully.

Given historical practice in drafting and implementing bilateral trade agreements with the EU, the Ukrainian side needs to actively promote the fullest consideration of national interests and the problems with attaining sustainable development in the process of negotiating an FTA+. At the moment, Ukraine lacks the methods necessary to carry out an assessment of the impact of liberalized trade on the environment and sustainable development such as the SIA. Still, by considering public opinion, the position of exporters and other interest groups, the Ukrainian delegation will gain additional arguments for these negotiations.

Practice shows that the benefits of signing a Free Trade Agreement with the European Union that will spur trade and economic cooperation on a transparent and liberalized basis outweigh or at least are equal to possible environmental losses that may be incurred as pressure on the environment increases in the process of growing economic activity and interest in protecting the environment declines as competition grows fiercer. Still, the actual impact of liberalized trade depends on the effectiveness and flexibility of environmental policy on the two sides. In this kind of situation, it is possible to anticipate that the concept of deeper free trade will become the catalyst for institutionalizing environmental policy in Ukraine as part of a national strategy and a sustainable growth action plan.

Technical and financial assistance for sustainable development and the environment

The European Union is Ukraine's largest donor. Most of its assistance comes through the TACIS program, especially its national, regional, cross-border and nuclear components. It also comes through the European Initiative for Democracy and Human Rights, and humanitarian and macro-financing assistance programs. TA via TACIS has been growing steadily: in 2002, it was EUR 47mn, in 2005 EUR 88mn, and an anticipated EUR 100mn for 2006. Altogether, EU assistance amounted to over EUR 2.2bn by the beginning of 2006.¹⁸⁰

Starting in 2007, the approach to providing Ukraine with technical assistance was supposed to change. Under the European Neighborhood Policy (ENP), assistance will be given through the new European Neighborhood and Partnership Instrument (ENPI), which replaces TACIS and a slew of thematic areas of funding. Expert assessments are that given the successful realization of the Ukraine – EU Action Plan, funding levels could double under this new instrument.¹⁸¹

This new instrument is expected to be more flexible and practical in terms of financial support for reforming priority areas that have been agreed in the Action Plan. In addition, it anticipates carrying out projects under a number of new initiatives, among which three stand out:

- The Cross-border Cooperation Program, which involves financing regional projects to deepen cooperation in border oblasts.
- The Technical Assistance and Information Exchange program or TAIEX, which involves targeted expert assistance in the process of approximating EU standards and adapting and enforcing European law.
- The long-term Twinning projects, designed to develop the contemporary, effective systems of administration needed to implement the *acquis communautaire* according to EU member standards.

Financial and technical assistance for projects under this instrument will be based on a number of goals that include both "encouraging sustainable growth" and

¹⁸⁰ EU relations with Ukraine: http://ec.europa.eu/comm/external_relations/ukraine/intro/index.htm#Sectoral.

¹⁸¹ "Ukraine could find itself without EU technical assistance in 2007," ICPS press release dated 14 December 2005.

"fostering environmental protection and improving the management of natural resources."¹⁸² To reach these goals, EU countries and institutions will spend no less than EUR 1.2bn annually under the Financial Prospects for 2007–2013 program, while the total amount of financing under this instrument could reach nearly EUR 15bn over the designated period. The size of expenditures to fund programs and projects in specific countries will depend not only and not so much on their needs as on their capacity to "absorb," that is, to effectively distribute and use these financial resources and their success in implementing the agreed reforms.

The signing of an FTA+ should become a clear signal to Ukraine's European partners about the country's readiness and capacity to ensure long-term economic growth according to high international standards. The provisions included in the FTA+ regarding cooperation in environmental protection will most likely become those priority areas to which the major share of financial assistance will be directed under the ENPI component.

In addition, the commitments agreed to by the two sides and enshrined in the agreement regarding support for sustainable growth and environmental protection could become a "roadmap" for targeting financial assistance and lines of credit for other European donors and IFIs, especially the EIB and EBRD. The cross-border component of cooperation, for instance, could also partly finance the European Regional Development Fund (ERDF), which will establish the grounds for drawing on once inaccessible "internal" funds of the EU to Ukrainian environmental projects.

Finally, establishing a common territory for the movement of goods and services on a transparent basis will foster a stronger position for Ukrainian manufacturers in competitions to participate in projects carried out under technical assistance programs. These kinds of tenders are held according to EU procurement standards, and although the advantages of member countries will remain strong for some time, Ukrainian companies will be on identical legal terms with companies from candidate countries like Turkey and Croatia and potential candidates like Albania, Bosnia and Herzegovina, Macedonia, Serbia, and Montenegro.

Thus, Ukraine's environmental policy under a working FTA+ with the European Union will most likely gain additional sources of financial and technical assistance. And although it is hard to compare the extent of this assistance with that which is granted in traditional priority spheres such as the pan-European network, nuclear safety and macro-stabilization, this assistance could become a key factor in resolving the main problems of lack of administrative and financial capacity.

¹⁸² Proposal for Regulating the EP and Establishing General Provisions for a European Neighborhood and Partnership Instrument. – 2004/0219 (COD).

