



Ukraine and the European Neighbourhood Policy

Ensuring the Free Movement of Goods and Services

Olga Shumylo

Abstract

The negotiation of a regional trade agreement between the EU and Ukraine is the next significant step towards Ukraine's deeper integration with the West. Drawing on analyses of official and independent analytical materials and statistical data, this paper explores the form such an arrangement should take – namely, which of the existing models would be an appropriate model for EU-Ukraine trade relations: a Free Trade Agreement, a Customs Union or something along the lines of the European Economic Area Agreement.

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Executive Summary

Since writing the first draft of this paper, many changes have occurred in the European Union and in Ukraine. Ukraine now has the political will to seek deeper integration with the European Union. The new pro-Western president and his team have committed themselves to making Ukraine a prosperous market economy that will seek its rightful place in the EU. As for the EU, the recent ‘no’ votes on the draft Constitution have revealed sizeable communication problems between the EU’s bureaucrats and citizens. The referenda have also raised questions about the feasibility of further EU enlargement.

After the 2004 enlargement, Ukraine was included in the European Neighbourhood Policy (ENP), an umbrella initiative of the Union. The major ‘carrot’ offered under the ENP is a stake in the EU’s Internal Market. Given the neighbours’ low degree of compliance with the Union, the EU’s offer of ‘all but institutions’ begged the question as to what type of reforms are needed to gain access to the Internal Market.

Only recently has Ukraine been offered a list of detailed ‘prescriptions’, implementation of which will create a solid base for deeper integration with the EU. The present conditions for deeper integration are, however, far from ideal. The EU granted market economy status to Ukraine only at the end of 2005 and Ukraine has yet to become a member of the WTO. The absence of proper legislation – in spheres such as agriculture, services and metallurgy – and poor enforcement of existing legislation are the main obstacles to WTO membership. Further problems encountered by the new government include regulatory bottlenecks that impede the development of domestic business and a dubious climate for foreign investors.

The creation of a free trade area between the EU and Ukraine is the next significant step towards Ukraine’s deeper integration with the West. Given the variety of forms that an FTA (Free Trade Agreement) with the EU can take, it is important to understand the possible pitfalls of existing arrangements with the EU. In most trade arrangements with the EU, the provisions on rules of origin and technical barriers to trade prove to be the most costly. The Ukrainian government should consider the advantages and disadvantages of existing arrangements with the EU, in preparation for future negotiations on an FTA.

A country’s desired degree of compliance with the EU’s Internal Market *acquis* is closely connected to the costs that such compliance will bear. Because Ukraine is not on an accession track yet, it is free to choose an optimal degree of compliance after assessing and weighing the country’s overall objectives against the associated costs. The compliance exercise should be driven by the demands of Ukraine’s economy, i.e. improvement of economic governance, economic growth and better access to EU markets. By itself, liberalisation of trade in goods or services between the two parties will not have a significant impact on the first two objectives. However, a synergy of policy domains, i.e. the free movement of goods and services coupled with the harmonisation of technical standards and attraction of investment and assistance, will lead to a more advanced outcome.

The inclusion of services in an EU-Ukraine FTA is important in order to produce a favourable cost-benefit ratio for both sides. If the future FTA covered services, this would help enhance the degree of trade between trading partners and increase the efficiency and productivity of Ukraine’s economy. By starting with and building on the IMF recommendations on financial services sector reform, Ukraine will create favourable conditions for the future liberalisation of services with the EU. In the aviation sector (and other sectors) it is important to ensure a synergy of actions, i.e. the free movement of goods and services and a considerable degree of compliance with the EU (safety standards) *acquis*. The initiative to put more emphasis on

services must come from Ukraine, but the EU should provide necessary assistance to the Ukrainian government.

The conditions and scope of further agreements between the EU and Ukraine will strongly depend on both EU and Ukrainian interest groups. Knowing and understanding the opponents of Ukraine's access to the EU market is important. The lobby groups at the EU level range from Euro-federations, Euro-associations and ad hoc coalitions of large companies, to individual large companies. The first two groups do not constitute a significant threat to Ukraine's exports due to their decreasing influence. Moreover, some of them (e.g. the European Round Table of Industrialists (ERT)) may provide support to both the Ukrainian government and the business community. The ad hoc coalitions may be less favourable towards Ukraine's exports due to their constant presence in the EU policy debate. By seeking alliances with European companies, however, Ukrainian companies could use the coalitions' lobbying practices to ensure their presence in the EU policy debate.

The Partnership and Cooperation Agreement envisions the creation of a free trade area between the EU and Ukraine. The scope and conditions of the potential FTA are open to discussion. Using a system of concentric circles it is possible to extrapolate to the existing approaches of EU's cooperation with non-member countries (the deeper the compliance with the *acquis*, the deeper the integration). These approaches range from Free Trade Agreements (e.g. with Mediterranean countries), to Customs Unions (e.g. with Turkey) and Common Markets (e.g. the European Economic Area). The paper will discuss the respective advantages and disadvantages of each option in detail. Special attention is paid to the example of EU-Swiss cooperation, which seems to be a reasonable model for EU-Ukraine cooperation in a long-term perspective.

The analysis of the above-mentioned options leads to the conclusion that the optimal approach for EU-Ukraine trade/economic cooperation would be a deeper Free Trade Agreement (or an FTA+). It should go further than the classic model of an FTA (i.e. EU-Meda arrangements), while keeping the model narrower than EU-EFTA cooperation. In order to make an FTA beneficial for both Ukraine and the EU, the partners should define the content of the agreement in accordance with cost and benefit criteria for both parties. For Ukraine it will be important to match its developmental tasks and the goal of EU market access. Therefore the compliance with EU *acquis* should be an economy-driven exercise.

UKRAINE AND THE EUROPEAN NEIGHBOURHOOD POLICY

ENSURING THE FREE MOVEMENT OF GOODS AND SERVICES

OLGA SHUMYLO

Introduction

The scope of the problem

With the dissolution of the Soviet Union, the European Union presented a credible model for the Central and Eastern European countries (CEECs). The EU's approach towards the CEECs was to promote their simultaneous political and economic liberalisation. It assisted in locking in domestic reforms by introducing conditionality and helping them become members of the Union by assisting with domestic institution-building. In contrast, the relationship between the EU and Ukraine (as well as with other Newly Independent States with the exception of Russia) has been ambiguous. Given the lack of EU interest, Ukraine has often been left alone to tackle the problems of both political and economic transformation. The EU has offered only ad hoc advice and support to Ukraine.

With the enlargement in 2004, Ukraine has become a direct neighbour of the Union. The Union has been keen to keep membership for Ukraine off the agenda, despite officially declaring the necessity to avoid dividing lines in Europe. The EU has been successful in keeping Ukraine outside its borders and institutions primarily through the European Neighbourhood Policy (ENP) and the inclusion of Ukraine in the 'ring of friends'. The only real 'carrot' that the EU has offered Ukraine is the promise – made to all neighbours – that it would open its markets in response to significant political and economic reform.

This paper does not seek to analyse the ENP, or its impact on Ukraine's transformation. Nor does it attempt to address the question of the appropriateness of such a policy for Ukraine. A superficial analysis, however, shows that the ENP, although necessarily broad in its structure and approach, is rather incomplete. On the positive side, the ENP contains some foreign policy tools, which proved to be successful in the CEECs, such as free trade agreements or technical assistance arrangements. The ENP is, however, vague with respect to how and when the 'carrot' will materialise for the partner countries. This leaves room for discussion of possible cooperation models between the EU and the neighbours and for the elaboration of recommendations for EU-Ukraine cooperation.

Despite the passing of the second anniversary of the ENP, the Ukrainian government has still to develop a vision of cooperation with the EU. The EU-Ukraine Partnership and Cooperation Agreement (PCA) will expire in spring 2008 and discussion of a new cooperation model is overdue. The debate about future EU-Ukraine cooperation is just starting to take place on both sides. The form of the new agreement to replace the PCA correlates strongly with the form and substance of a future EU-Ukraine FTA. It is important to ensure that the future FTA, and a new agreement to replace the PCA, are beneficial to both sides. Therefore it is useful to unpack the current EU-Ukraine relations, especially the preconditions for an EU-Ukraine FTA, and to analyse the options of EU cooperation with third countries or groups of countries.

This paper focuses on the trade/economic aspects of EU-Ukraine relations. It answers the question of how to ensure that Ukraine receives a ‘carrot’ in the form of a Free Trade Agreement with the EU and the form this ‘carrot’ should take – namely, which of the existing models would be an appropriate model for EU-Ukraine relations.

The methodology

This paper is based on analyses of official and independent analytical materials and statistical data. The recommendations regarding options for deeper integration between Ukraine and the EU are based on an assessment of regional trade agreements: the Free Trade Agreements, the Customs Union and the European Economic Area Agreement. The analysis of interest groups is based on theoretical and empirical studies of interest groups in the EU and Ukraine. A number of consultations were held with Ukrainian officials and independent experts, and representatives of the European Commission in the process of drafting the paper.

1. Assessing the Preconditions for Deeper Integration

1.1 Legal basis for EU-Ukraine cooperation

The legal basis for EU-Ukraine relations is the Partnership and Cooperation Agreement (PCA) of June 1994.¹ The PCA provides a framework for cooperation in political, economic, social and other spheres. It aims to support the consolidation of democracy in Ukraine, the development of the country’s economy and its transformation into a functioning market economy. However, the PCA does not touch upon the issue of membership – along with the rest of the former Soviet Union (FSU) republics. Ukraine has been excluded from the ‘accession circle’.

The EU enlargement of 2004 shifted the Union’s focus onto Ukraine, as it became a direct neighbour. EU policy towards Ukraine was then subsumed under the European Neighbourhood Policy (ENP), an ambiguous ‘umbrella’ policy directing the EU’s relations with neighbouring countries. The ENP contains various ‘carrots’ for neighbours, ranging from “more effective political dialogue” and “perspectives of integration into transport, energy and telecommunications networks” to “enhanced and improved [financial] assistance”.² The main incentive for neighbours, however, is a stake in the EU’s Internal Market.

Under the ENP, action plans are developed for each partner country. The action plans are the first attempt to “operationalise EU prescriptions by linking them to domestic policy programmes of the partner states or EU policy norms and standards as an external anchor”.³ The EU-Ukraine Action Plan aims to build a foundation for further economic integration, including a free trade area between the EU and Ukraine. The Action Plan consists of chapters on, for example, the political Copenhagen criteria, the Single Market *acquis*, and product and process *acquis*. In contrast to the lack of specifics in the PCA, the Action Plan contains prescriptions for harmonisation with EU norms and standards. Nonetheless, the sequencing and depth of harmonisation depend on Ukraine. This might therefore work as a ‘light’ commitment device for Ukrainian reformers.

¹ The PCA came into force in 1998 after ratification by all the EU member states and the Ukrainian parliament.

² W. Wallace, *Looking after the Neighbourhood: Responsibilities for the EU-25*, Notre Europe Policy Paper No. 4, Notre Europe, Paris, p.11.

³ M. Emerson and G. Noutcheva, *From the Barcelona Process to the Neighbourhood Policy: Assessment and Open Issues*, CEPS Working Document No. 220, CEPS, Brussels, March 2005, p. 23.

On 1 December 2005, at the EU-Ukraine Summit in Kyiv, EU representatives welcomed the progress Ukraine has achieved in implementing the EU-Ukraine Action Plan. Ukraine's commitment to the shared values of democracy, rule of law and respect for human rights was viewed as an important achievement that would help deepen relations between the EU and Ukraine. Progress in promoting economic reforms was acknowledged, although the need to continue the reform process was also emphasised.⁴ The successful implementation of the Action Plan, along with other agreements, will bring deeper integration of Ukraine into the EU. Once the political priorities of the Action Plan are addressed, the EU and Ukraine will start consultations on a new enhanced agreement to replace the Partnership and Cooperation Agreement.

1.2 EU-Ukraine trade relations

Ukraine maintains close trade relations with the CIS (Commonwealth of Independent States), and in particular with Russia. However, the enlarged EU has replaced Russia as Ukraine's primary trade partner, accounting for 32.5% and 29.3% of its external trade share in 2003 and 2004, respectively; whereas the share of Ukrainian exports to the CIS for the same years was 27.5% and 27.1%, respectively.

Ukraine remains a small supplier of imports to the EU market, however. In 2003, the Ukrainian share of total extra-EU imports comprised only 0.7%.⁵ At the broad sectoral, level there are only two sectors where the Ukraine's share of EU imports exceeds 1%: raw hides and skins, and iron and steel. Relative to other countries, EU imports from Ukraine are concentrated upon a small number of product lines. In 2003, an insignificant number of the available 1200 product categories (at 4-digit CN) were covered.⁶ The product structure of Ukrainian exports to CIS countries is considerably broader than that of exports to the EU.

EU-Ukraine trade in services totalled about \$ 2 billion in 2004, an increase of 10.8% over 2003. Within Ukraine's share of services received from residents of the EU, transport services constituted 20.7%; insurance services, 18.3%; and travel services, 17.8%. The most dynamic growth of trade in services was observed in trade with private persons (an improvement of 3.2 percentage points compared to 2003), financial services (1.8), communication services (1.7), legal and accounting services (1.6) and transport services (1.4).⁷

A significant proportion of Ukrainian goods entering the EU market are eligible for the General System of Preferences (GSP). Non-sensitive products are exported to the EU with zero tariffs, whereas the MFN duty for semi-sensitive products is reduced by 65%. The current structure of Ukraine's trade is such that the GSP has the potential to bring significant benefits, but in practice these benefits are not fully realised. Large values of exports to the EU, although eligible, do not receive GSP treatment. The underutilisation of the GSP may reflect many exporters' lack of knowledge about the scheme and the benefits it offers. It may also be that they are having difficulty satisfying the conditions for products of origin or problems in obtaining the necessary certificates to demonstrate compliance with these conditions.

⁴ Council of the European Union, EU-Ukraine Summit Joint Statement, C/05/337, Kyiv, 1 December 2005.

⁵ Abstracted from the Fact Sheet on Ukraine of the European Commission DG Trade., A2/CG/SG/WB, Brussels, May 2004.

⁶ Ibid.

⁷ National Bank of Ukraine, *Balance of Payments of Ukraine for 2004*, Quarterly Analytical-Statistical Publication, Kyiv, 2005.

European FDI flows towards Ukraine could also be improved. In 2004, FDI from the EU-25 was just more than \$465 million.⁸ An improvement in the investment climate, notably through a more effective enforcement of adopted legislation and the completion of the reform process, is essential if Ukraine is to attract more investment. The main obstacles faced by EU investors are frequent changes in regulations affecting foreign trade, lack of transparency, incomplete implementation of laws, discriminatory regulations, corruption, and red tape.

Table 1. EU-25 foreign direct investment stocks in Ukraine(\$ millions)*

	1 January 04	1 April 04	1 July 04	1 October 04	1 January 05
EU-25	3925.0	4159.5	4375.2	4557	4652.3

* Including revenues from privatisation.

Source: National Bank of Ukraine, *Balance of Payments of Ukraine for 200.*, Quarterly Analytical-Statistical Publication, Kyiv, 2005.

1.3 Market economy status and WTO membership: Preconditions for deeper integration with the EU

Economic integration with the EU is a double-edged sword. On the one hand, integration will guarantee Ukraine's economic development; on the other, it will encourage further reform. Unfortunately for Ukraine, the initial steps required for integration have yet to be completed. Ukraine has only recently received Market Economy Status (MES) from the EU and is not yet a member of the World Trade Organisation (WTO). The conditions of being a member of the WTO are not formal. However, integration into the world economy through a certain degree of liberalisation is crucial if Ukraine is to achieve deeper integration with the EU.

The negotiations with the EU over the MES took almost four years. The status was granted on 1 December 2005, at the EU-Ukraine Summit held in Kyiv, after Ukraine finally met all technical criteria for the granting of the status. One benefit of MES will be to cushion the impact of anti-dumping lawsuits on Ukrainian exporters, especially exporters of ferrous metals and chemicals,⁹ as the anti-dumping measures will no longer be applied to the whole country but to separate companies. The national economy will become increasingly predictable and stable as a result. Hence, MES will serve as an important signal for foreign investors. By granting the status, the EU set an example for the US, which continues to delay the granting of MES to Ukraine. Moreover, a problematic issue of bilateral relations between the EU and Ukraine will have been removed from the agenda, and the two parties will be able to move towards a discussion of deeper integration once Ukraine joins the WTO.

An important immediate advantage of WTO membership for less developed countries is access to international markets. Ukraine should expect a number of benefits from WTO membership, such as improved market access, as well as access to dispute-settlement mechanisms. Moreover, WTO membership would provide incentives for further domestic reforms needed to conform to international standards and procedures. It would also stimulate further FDI flows. The benefits of WTO accession for Ukraine will be reflected in GDP growth of at least 1.9%, and an increase in FDI flows and exports to the EU by 50 and 15% respectively. In general, WTO accession would alleviate some current problems in EU-Ukraine relations by lowering customs duties and

⁸ Ibid.

⁹ This applies especially to exporters dealing with eight groups of commodities: seamless pipes, welded pipes, steel cables and wires, carbamide, ammonium nitrate, ammonium saltpeter, silicon carbamide and potassium chloride.

cutting subsidies to national producers. WTO accession is a necessary precondition for enabling Ukraine to join a free trade area with the EU.

Although the benefits are apparent and WTO membership has been defined as a precondition for deeper integration with the EU, Ukraine has yet to become a member of the WTO. The negotiation process regarding Ukraine's membership has taken more than a decade. One of the major reasons for the slow progress of negotiations has been a large number of negotiation counteragents. One-third of the required bilateral agreements were signed by 2004.¹⁰ The agreements with 'problematic' WTO members, such as Australia, China and the US, are still to be signed. The US is concerned about the protection of property rights in Ukraine, and about the illegal production and dissemination of CD products. Although the required legislation has already been adopted by Ukraine, it is not being effectively implemented. The delay in the signing of an US-Ukraine protocol depends on the exemption of Ukraine from the Jackson-Vanik amendment and on the US granting Ukraine MES. The Senate has adopted a bill to exempt Ukraine from the amendment, which still has to be approved by the House of Representatives and signed by the president. Australia's main requirement is a reduction of customs tariffs to 10% and an increase in the quota for raw sugar imports.

A second major obstacle to WTO membership is the previous regime's failure to address the need to adapt legislation for WTO membership, which is of particular importance in the spheres of services, agriculture, sanitary and phytosanitary control, car manufacturing and metallurgy. The new government only recently adopted a series of decisions to ensure Ukraine's accession to the WTO and submitted the draft laws on changes in the above spheres.

Box 1. Decisions adopted by the government to ensure Ukraine's accession to the WTO

The new government has adopted a series of decisions to ensure the accession of Ukraine to the WTO, the most important of which are:

- Approved the consolidated tariff proposal of Ukraine on market access in goods, and the schedule of specific access commitments of Ukraine in goods and services and commitments of Ukraine on trade regime (Decree, 30.05.2005 N171);
 - Approved the procedure of fees payment for actions related to the protection of intellectual property objects (envisages the application of national regime and regime of most favoured nation clause when paying dues for actions concerning intellectual property rights protection under Articles 3 and 4 of TRIPS);
 - Created a national information centre for processing inquiries by WTO member states and information on WTO within the Ministry of Economy (Decree, 31.05.05 N 408);
 - Introduced changes to model agreement on implementation of investment project on priority development territories and special (free) economic areas (Decree, 30.05.05 N 404);
 - Cancelled the decree of the cabinet of ministers on the procedure of registering oil exports contracts. The Government's decree on zero oil exports quota will remain in force till the end of 2005. (Decree of the CMU from 28.05.05 N 406); and
 - Cancelled decree of the cabinet of ministers on the possibility of using minimal prices mechanism on national and imported alcohol drinks (Decree, 28.05.05 N 407).
- Source:* Government of Ukraine, Implementation of EU-Ukraine Action Plan, presentation, Kyiv, June 2005.

¹⁰ Ukraine has signed one-third of all protocols in 2004. As of 1 January 2005, Ukraine has signed 30 bilateral agreements with the members of the Working Group on accession to the WTO. The latest agreement was signed with Indonesia in July 2005. The country continues negotiations with another 19 members.

The government's attempt to pass, via an ad hoc procedure, all WTO-related laws in a single package has met significant resistance in the Parliament. To date, the Parliament passed 12 laws required for WTO accession in the second reading, and two draft laws in the first reading. Another two draft laws have been sent for the revision.

The draft laws that have been passed in the second reading during the 7th Parliamentary Session are as follows:

1. Draft Law on Incorporating Amendments into Certain Laws Concerning the Harmonisation of National Legislation with the Requirements of Multilateral WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) (# 7032)¹¹
2. Draft Law on Introduction of Export Duty of Some Oil-Bearing Crops (# 5700-2)¹²
3. Draft Law on Incorporating Amendments into the 'Law on Insurance' (#7564-1)¹³
4. Draft Law on Incorporating Amendments to the 'Law on Audit Activities'¹⁴
5. Draft Law on Cancellation of Ban on Importing Vehicles (Automobiles, Trucks and Buses) that Have Been in Use for More than Five Years¹⁵
6. Draft Law (# 7569) that brings provision 4 of the 'Law on Developing Automobile Industry in Ukraine' into compliance with the country's obligations in the framework of WTO accession and the PCA¹⁶
7. Draft Law on Standards, Technical Regulations and Procedures for Determining Compliance
8. Draft Law on Incorporating Changes to the Law on Veterinary Medicine
9. Draft Law on Incorporating Changes regarding special investigations to the Law on Using Special Measures with Regard to Imports into Ukraine
10. Draft Law on Incorporating Changes to the Law on Protecting Domestic Manufacturers from Dumped Imports
11. Draft Law on Incorporating Changes to certain pieces of Ukrainian legislation regarding health and epidemiological standards for food products

¹¹ Initially, this draft law aimed at solving the dispute over 'pirate disks' in Ukraine's trade negotiations with the USA, although the law was not directly linked with Ukraine's accession to the WTO. On the one hand, it aimed at helping Ukraine meet its obligations under a number of international agreements; on the other hand, it would help ensure the protection of intellectual property rights that have been neglected in Ukraine. By so doing, Ukraine would link itself to a worldwide fight against black markets.

¹² It provides for a gradual decrease of the export duty for sunflower, flax and colza seeds after Ukraine's accession to the WTO. The duty will be decreased by 1% annually until it reaches 10%.

¹³ It envisions the liberalisation of Ukraine's insurance market upon the country's accession to the WTO. Non-resident insurance companies will be given access to the insurance market in five years after accession.

¹⁴ The amendment eliminates the mandatory resident status for audit companies.

¹⁵ It changes the rules of the game for car importers by shifting the threshold from five to eight years on used cars. In addition, starting from January 2006, Ukraine will introduce European emission standards (EURO-2) for vehicles more than five years old. The result is a tightening of ecological protections and technical requirements for vehicles that are sold and/or used in Ukraine.

¹⁶ It abolishes the provision requiring domestic car manufacturers to ensure that at least 50% of a vehicle's parts originate in Ukraine.

12. Draft Law on Incorporating Changes to the Law on Protecting the Rights of Consumers

The draft laws that have been passed in the first reading are:

- Draft Law on Lifting a Ban on Export of Alloyed Ferrous Metal Scrap and Non-ferrous Metal Scrap and Semi-finished Goods Containing Either
- Draft Law on Incorporating Amendments into the ‘Law on Banks and Banking Activities’ (# 7274)

During November and December 2005,¹⁷ an additional five draft laws passed first reading. These reduced customs duties on scrap steel, live cattle and rawhide, and simplified customs procedures for imported goods. Most of the adopted laws had broad-based support among MPs as they obviously represented more gains than losses for both domestic producers and domestic consumers.¹⁸

Despite the adoption of a significant number of laws needed for the country’s accession to the WTO, three important draft laws were not adopted during the 7th Parliamentary Session.¹⁹ A strong agricultural lobby was behind the failure of the Parliament to pass technical amendments to the Law on State Regulation of Sugar Production and Sale in the first reading, which would have led to the cancellation of the obligatory export of sugar that has been produced from imported crude sugar. Additionally, the law on sugar production would have abolished the B and C quotas²⁰ that contradict the WTO agreement on agriculture. A strong metallurgical lobby prevented the adoption of draft law #7563,²¹ which provided, starting from 1 January 2006, for the trimming of export customs duties on ferrous metal scrap from €30 to €25 per tonne, and from 1 January 2007, to €18 per tonne. Finally, the Socialist faction prevented the last of the three draft laws (#7567), which would have amended the Law on Export Duty for Live Cattle and Hide, from making the parliamentary agenda.

During the November/December session, the Parliament rejected the Draft Law on Changing Certain Laws of Ukraine to Comply with WTO Standards for the third time, which, among others provisions, abolishes the concept of B and C quotas as part of the mechanism for internally regulating the sugar market²² and removes limits on the import of vehicles older than eight years. Moreover, the Parliament did not approve draft laws that would:

- permit non-residents to provide legal services on the territory of Ukraine; and
- increase the limit on the share of statutory funds in broadcasting companies that may be owned by non-residents from 30% to 35%;
- permit branches of foreign banks to operate on the territory of Ukraine;

¹⁷ 8th session of the Parliament.

¹⁸ International Centre for Policy Studies (ICPS), Political Commentary, Kyiv, December 2005, p. 15.

¹⁹ The 7th Parliamentary Session was held from February-July 2005.

²⁰ Quotas A, B and C are unique to Ukraine. Quota A refers to supply of sugar for Ukraine’s internal market for internal use; quota B, quantity of sugar supplied to other countries in accordance with international agreements; and quota C, sugar produced outside of quotas A and B and to be sold outside of Ukraine only.

²¹ The Draft Law on Incorporating Amendments to Article 1 of the ‘Law on Export Duty for Ferrous Metal Scrap’ (#7563).

²² For more on the regulation of the sugar market, see ICPS, *Quarterly Predictions*, Q3 2005, Kyiv, pp. 55–56.

- cancel the ban on exporting scrap alloyed steel, scrap non-ferrous metals and semi-finished products containing either.²³

The Parliament still needs to adopt a number of draft laws, in particular on export duties on iron and steel scrap, sanitary and phytosanitary inspections, quotas for raw sugar imports and the regulation of sugar refining (for an approximate list of the draft laws needed for Ukraine's accession to the WTO, see Annex 1).²⁴ The adoption of these laws would have a two-fold impact on Ukrainian producers. On the positive side, the quality of Ukrainian products would improve significantly, which would lead to increased product competitiveness. The negative effect of the new laws would be an increase in domestic prices for raw materials and in competition between Ukrainian producers and importers.

Table 2. The main 'problematic' bills required for WTO accession as of 2 December 2005

Name of bill	Purpose	Prospects
Cancelling the Ban on Exporting Scrap Alloyed Steel, Scrap Non-ferrous Metals, and Semi-finished Products Containing Either	Allows non-ferrous scrap to be exported	Little support in the Rada (only pro-government factions; SPU against). Not expected to come up again in December 2005.
Changing the Law on Banks and Banking Activity	Allows non-resident banks to open branches on the territory of Ukraine	Passed first reading in July 2005. In November, the SPU and a large number of deputies from pro-government factions failed to support it. Not expected to come up again in December 2005.
Export Duty on Ferrous By-products and Scrap	A gradual reduction in the export duty on ferrous by-products and scrap from € 30/tonne to € 18/tonne	Barely passed first reading in November 2005 (228 votes) thanks to the support of NP and PIE. Up for second reading 14 December 2005.
Changing Certain Acts of Legislation of Ukraine in order to Harmonise Them with WTO Standards	A substantial set of changes, including reforming the system of quotas on the sugar market and cancelling the ban on importing older cars	Faces the greatest amount of opposition in the VR as it simultaneously affects the interests of several branches of industry. Rejected three times by the legislature. Not expected to be considered again in December 2005.

Sources: Verkhovna Rada and ICPS Political Commentary.

Unfortunately, the government was incapable of explicitly articulating the costs and benefits of WTO membership to the Parliament. Aside from that, the 'old guard', which is still present in the incumbent administration, failed to recognise WTO membership as a window of opportunity for Ukraine in a globalising world.

²³ Ibid.

²⁴ The number of draft laws to be adopted is taken from a report of the Interfax news agency (www.interfax.kiev.ua). Private discussions with the representatives of the Ukrainian government revealed that there was no clear understanding on how many laws should be adopted to ensure Ukraine's accession to the WTO. The Ministry of Economy has been assigned to prepare an analysis of draft laws to be adopted by the Parliament in the framework of pre-accession obligations.

These and other factors created internal obstacles to the country's accession to the WTO. Despite the president's adherence to the accession process, the contradictory positions within the government raise concern over the process.²⁵ There is a good chance that these obstacles could be overcome if consultations were to be held with parliamentary groups and factions, in particular with the agricultural and metallurgical lobbies. Fortunately the president has expressed his readiness to mediate such consultations.

The external obstacles to WTO accession – i.e. the Russian factor and the remaining protocols with Australia, the US and China – are too difficult to be solved by Ukraine alone. Ukraine therefore needs strong political support from the EU. In fact, the EU has declared its readiness to support Ukraine's accession to the WTO. But given the ongoing debate over agricultural issues within the WTO, it is unlikely that the EU will be in a position to assist Ukraine in its negotiations with the USA and Australia.

Although accession to the WTO was not feasible by the end of 2005, it is important for both the government and the Parliament to continue focusing on the WTO accession issues, i.e. bilateral negotiations and the adoption of necessary draft laws, for 2006 poses less favourable conditions for the accession process. The parliamentary elections (held 26 March 2006) are diverting the Parliament's attention to securing public support. The outcome of the Doha Round and Russia's accession to the WTO may impede Ukraine's accession even in 2006.

1.4 Additional immediate tasks

Market Economy Status and WTO membership, although important, are not a panacea for economic development and improved economic governance. To achieve either of these goals, increased trade with the EU is crucial. This begs the question as to what hinders EU-Ukraine trade flows. Taking into account relatively low tariffs on both sides, the importance of non-tariff and non-border obstacles becomes apparent. First of all, Ukraine exhibits non-conformity with EU standards and procedures.

Administrative barriers to entrepreneurial activity and a dubious climate for investment are equally important constraints. Only some of the above barriers will be overcome with accession to the WTO, as policy harmonisation under the WTO is limited to only a few sectors, such as food safety, intellectual property, competition and environment.

The government should do additional 'homework' on creating a positive business environment and favourable conditions for investment. Special measures should be adopted to tackle problems related to state aids and competition rules. Taking into account the complexity of the reforms needed, the following scope and sequencing of reforms could be effective:²⁶ improvement of the regulatory environment, reform of the tax and social contributions systems, reform of the system of public governance and protection of property rights.

²⁵ The secretary of the National Security and Defence Council of Ukraine revealed plans to synchronise Ukraine's accession to the WTO with that of Russia. On the other hand, the Ministry of Foreign Affairs declared Ukraine will adhere to the goal of joining the WTO by the end of 2005. 'Ukraine Will Help Russian Join the WTO' and 'Ukraine Will Stick to Its Plan to Join the WTO by the End of the Year' (respectively), 10 October 2005, www.korrespondent.net.

²⁶ ICPS, *Improving the Business Environment in Ukraine*, ICPS Discussion Paper, Kyiv, 2004, p. 16.

2. Towards Access to the EU's Single Market – Pitfalls

2.1 Rules of origin and technical barriers to trade

The creation of an EU-Ukraine free trade area is a long-term goal. At this stage, analysis of several possible trade arrangements will allow us to draw conclusions and develop recommendations for Ukraine in its negotiations on an FTA with the EU. In trade arrangements with the EU, the most costly provisions are related to rules of origin (RoO) and technical barriers to trade (TBT).

The Union's rules of origin define the conditions that a product must satisfy if it is to be considered to originate in a country that has preferential access to EU markets. The EU aims, with the RoO, to protect its markets from the products of non-participants that could be redirected through EU free trade partners, in this way avoiding the payment of customs duties. The RoO are very restrictive, especially in regard to technical standards. They impose additional costs on the participants of free trade areas. Moreover, the costs of proving origin are even higher, especially for countries with poorly developed customs, which minimises the value of any preferential arrangements with the EU.

Several policy papers call for the simplification of RoO. However, there is no progress in this area yet. Ukraine should bear in mind the destructiveness of the rules of origin when negotiating its free trade agreement with the EU. The solution could be either to participate in the outwards processing schemes established by the EU, or to join the customs union with the EU, which would automatically mitigate the RoO problem.

Technical barriers to trade arise whenever producers have to alter their products to comply with differing partner country requirements, for example in the areas of health, safety, environmental and consumer protection. The TBT regulations aim at ensuring that the product complies with the specification.²⁷ The compliance imposes significant costs on producers and exporters, and affects the production cycle. The EU seeks to tackle this problem in order to avoid the fragmentation of EU markets. In the areas where harmonised product legislation exists the Mutual Recognition Principle (MRP) is enforced. In other cases, harmonisation of the partner country's technical standards to those of the EU must be ensured. Since product legislation in third countries differs from that of the EU, the TBT becomes a significant problem in terms of the costs imposed on both the government and business community.

Ukrainian product legislation differs significantly from that of the EU. Therefore, Ukraine must identify priority sectors for alignment with EU legislation and ensure harmonisation with EU technical regulations in these defined sectors. The medium-term solution is Ukrainian participation in an Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA). The potential pitfalls in relations with the EU should be taken into account by the Ukrainian government when negotiating a free trade agreement.

2.2 Costs of compliance²⁸

Conformity with EU standards and regulations leads us to the question of the costs imposed by compliance. Having been constrained by the obligation to adopt the *acquis* prior to accession, CEECs had no choice but to accept the costs of compliance. Transition periods for the

²⁷ P. Brenton, J. Sheehy and M. Vancauteren, *Technical Barriers to Trade in the European Union: Importance for the Accession Countries*, CEPS Working Document No. 144, Brussels, April 2000, p. 3.

²⁸ J. N. Uñez Ferrer, *Costing European Union Membership for Albania*, CEPS (unpublished) Report, Brussels, 2005.

implementation of norms and standards were allowed only for alignment with ‘expensive’ *acquis* (i.e. environmental, transport and agriculture). Administrative capacity-building and the harmonisation of legislation necessary for the removal of the TBTs counted for about half of the costs. However, the EU’s technical assistance programmes (i.e. Phare, ISPA, and SAPARD) covered a substantial part of the compliance costs.

The non-candidate countries, such as Ukraine, do not benefit from such assistance. Therefore it is important to assess the overall objectives of the country, weigh them against the costs of compliance, and choose the correct scope and sequencing for the approximation between EU and domestic laws and practices. This approximation should be driven by the demands of Ukraine’s economy, i.e. better access to the EU markets. Measures enabling better access should be given priority. In this respect, the TBT directives should be adopted and the infrastructure for transport should be developed. Moreover, attention should be paid to the government’s administrative capacity. The environmental *acquis* could be postponed until a later stage.

2.2.1 Technical assistance to Ukraine

Ukraine still benefits from the Tacis Programme. For the period 2002–2006, assistance under the national Tacis programme has focused on three priority areas: i) support for institutional, legal and administrative reform, ii) support to the private sector and economic development, and iii) support in addressing the social consequences of transition. Tacis funding for national programmes in Ukraine has been substantially increased over the period 2002–06, from €47 million in 2002 to €88 million in 2005 and an expected €100 million in 2006. In 2005, the EU nearly tripled (from €90,000 to €1,025,000) its support to civil society organisations in Ukraine through micro-grants under the European Initiative for Democracy and Human Rights.²⁹

The European Neighbourhood and Partnership Instrument (ENPI) is now under development and will serve as the framework for assistance within the broader European Neighbourhood Policy. The Commission is preparing to launch the ENPI in the EU 2007–13 financial perspective. The ENPI will replace the current Tacis programme as well as a number of thematic activities. Under the ENPI, assistance will not be limited to technical assistance but will cover a wider range of instruments and delivery mechanisms, including twinning and the Technical Assistance Information Exchange Office (TAIEX).

2.2.2 European Neighbourhood and Partnership Instrument: Assistance for compliance?

The European Commission is assisting candidate countries in the adoption of the *acquis communautaire* by encouraging partnerships between member states and candidate countries through twinning arrangements. TAIEX has been designed to provide five main services: documentation, information and advice on Single Market Legislation, workshops and seminars, study visits to the European Commission and member states; expertise to the beneficiary countries, and finally, the compilation of databases on the provision of technical assistance and the results achieved.

The spread of twinning arrangements and TAIEX activities in Ukraine is a positive step from the Commission’s side. It follows the assistance approaches used for the accession countries.

²⁹ Data taken from the website of the European Commission (http://www.europa.eu.int/comm/external_relations/ceeca/tacis/index.htm).

However, at present, EU technical assistance is not designed to directly support implementation of the EU-Ukraine Action Plan. The Commission envisages coordination of ENPI assistance with the objectives of the Action Plan only from 2007. Given that the Action Plan will be almost fully implemented by this time, it would be important to redirect ENPI assistance for the fulfilment of further objectives, i.e. reforms needed to ensure Ukraine's compliance with the *acquis* and its access to the EU's Internal Market.

2.3 A synergy between policy domains

Access to the EU's Internal Market implies conformity with EU standards and regulations and raises the question of the costs of compliance. It is up to the Ukrainian authorities to decide on the degree of compliance. The approximation of national legislation with the *acquis* and the adoption of European standards should be driven by the demands and capacities of Ukraine's economy. The example of the civil aviation sector is used below to illustrate synergy between policy actions, such as between the free movement of goods and services, compliance with standards, and investment/technical assistance.

The European Union seeks to create a common aviation area through the improvement of cooperation with its neighbours. Negotiations on this issue between the EU and Ukraine would aim at the progressive integration of Ukraine's aviation sector into European structures.³⁰ Two objectives could then be pursued: 1) opening the markets in order to increase market opportunities for the industry and consumers, and 2) ensuring regulatory convergence and cooperation in fields such as aviation safety, aviation security, environmental protection, competition rules and industrial cooperation.³¹

Ukraine has shown an interest in closer cooperation with the EU in the aviation sector. The country started to implement market-oriented transport policy in order to open its market towards the EU member states and to ensure the compliance with European norms and standards. A first important step for Ukraine's integration into the European air transport market was the signing of a Horizontal Agreement on Aviation at the last EU-Ukraine Summit. It will ensure the removal of national restrictions in the bilateral air services agreements between the member states and Ukraine. Hence, it will allow any EU airline to operate flights between any EU member states and Ukraine.

However, the free trade in services will not be enough for both the EU and Ukraine to ensure market access. In the case of Ukraine, it is important to modernise the aviation industry and to increase the safety and environmental standards of the country's aircraft. This could be guaranteed if Ukraine is allowed to buy new aircraft without import duties. At the same time, there is a need to remove infrastructure bottlenecks and to fully implement European safety oversight requirements. On the one hand, the European Union could provide assistance to Ukraine to implement necessary changes. On the other hand, the need to develop infrastructure would attract domestic and foreign investment. By combining the above-mentioned actions, Ukraine will not only gain market access but will also improve domestic economic governance and create better conditions for business and consumers.

³⁰ The Commission hopes to receive a mandate to start negotiations during the Austrian Presidency.

³¹ European Commission, Developing a Common Aviation Area with Ukraine, Communication from the Commission, COM(2005) 451 final, Brussels, 27 September 2005.

3. Access to the Single Market: Emphasis on services

3.1 Rationale

Recent studies on EU-Turkish and EU-Mediterranean relations reveal that free trade in goods between the parties is neither enough for Turkey nor will it be enough for the Mediterranean countries. The incorporation of the services sector would enhance the degree of trade between the trading partners and would lead to potential benefits in the form of increased efficiency and productivity of countries' economies. The welfare benefits of liberalisation would make up between 13–15% of real GDP.³² Last but not least, in order to get access to the EU's markets these countries will be obliged to introduce EU regulatory norms and standards, which will help improve their economic governance.

The main reason for the exclusion of services from the agenda in the past was a fear that Turkish and Mediterranean service providers would immigrate to the EU. However, border barriers (i.e. tariffs and quotas) are much lower in contrast to the past, which allows for widening the scope of free trade agreements between partners.

Box 2. The EU's focus on services

The attention paid to the services sector is growing within the EU itself. Services comprise up to 80% of the EU member states' economies. The free movement of services is a cornerstone of the EU Internal Market and covers the freedom of providing services and the freedom of those who provide these services. The success of the Internal Market project is unprecedented. However, despite the successes, key areas in the Internal Market remain untapped, especially with regard to services. The Commission's recent proposal for a Directive on Services in the Internal Market seeks to increase the free flow of services throughout the EU, by requiring member states to cut red tape that can currently prevent business from offering their services across borders or from opening premises in other member states. (For more information on the EU Services Directive, see Annex 2).

Although the liberalisation of trade between the EU and Ukraine is a long-term project, it is worth analysing the costs and benefits of the liberalisation of the services sector and possible implications in political and economic terms. Trade in services is often hindered by non-border issues, such as red tape and/or uncertain rules of the game, in contrast to tariff and quotas restrictions in the goods-trading sectors. The following section will therefore provide a brief inventory of service sector reform in Ukraine, as well as a list of the tasks necessary for the liberalisation of services between the EU and Ukraine. The civil aviation sector and the financial services sector will be used as two different case studies to explain Ukraine's degree of compliance with EU standards. The case of civil aviation calls for a synergy of policy actions (i.e. free movement of goods and services, investment and safety standards); whereas the reform of the financial services sector could be based on compliance with international standards.

3.2 Inventory

The Partnership and Cooperation Agreement (PCA) contains rather vague commitments on trade in services between the EU and Ukraine. Chapter III (cross-border supply of services) envisions the gradual abolition of restrictions to progressively allow the supply of services

³² M. McQueen, "The EU's Free-Trade Agreements with Developing Countries: A Case of Wishful Thinking?", *The World Economy*, Vol. 25, No.10, 2002, pp. 1531–1534(4).

between the EU and Ukraine in certain sectors. The Action Plan did not define services sector reform as a top priority. However, some concrete steps have been identified:

- preparation of the implementation of Ukraine's commitments on services in WTO accession negotiations;
- completion of a review of national legislation by Ukraine to identify barriers to the provision of services;
- ensuring coordination between all relevant administrative entities in order to facilitate the supply of services and to eliminate barriers to trade in services; and
- ensuring the effective implementation of legislation that sets out the basic principles of non-discrimination, introducing more detailed secondary or sector-specific legislation as necessary.

The list of service sectors that are important to a deeper integration between the EU and Ukraine is extensive. A further part of this section will look at two examples of fast-growing service sectors – the air services and the financial services sectors. Each of these sectors will be unpacked in terms of its current status, its importance to the EU, its approximation with the EU *acquis* and plans for further reform in accordance with the EU-Ukraine Action Plan.

3.3 Air services³³

The air services market is one of the country's fastest-growing markets. The development of both regional and international transport has been strongly influenced by the growth of the country's economy. The expansion of transit traffic of the last few years served as an additional push factor for transport sector development. The government expanded air passenger traffic through introducing cross-subsidies for regional transport in 2003–04 and abolishing visa requirements for citizens of the EU member states and a number of other countries in 2005.³⁴ Ukraine's convenient geographical location as well as the existing international airports create favourable conditions for further development of air transport in Ukraine. Even if this segment has a small share of Ukraine's overall transport sector now, its potential is comparable to that of the country's transit pipeline networks.

The aviation markets of the EU and Ukraine are closely connected, and the air traffic between them is growing fast. The number of passengers travelling between the EU and Ukraine by air transport grew to 1.5 million passengers in 2004, which is 25% more than in 2003.³⁵ Ukraine has signed bilateral agreements on air services with all EU member states. The dialogue on air services between the Union and Ukraine has become more intensified during the last year. In December 2005, Ukraine signed a Horizontal Agreement with the EU, which should be viewed as a first step towards the creation of a Common Aviation Area of the EU and Ukraine.³⁶ This

³³ This sub-section draws heavily on ICPS, *Problems and Prospects for Developing the Air Passenger Carrier Market in Ukraine*, report on the Roundtable Which Strategy Should Ukraine Follow for Air Transport in the "Open Skies" Context?, Kyiv, ICPS, 2005.

³⁴ ICPS Occasional Paper 2005, *Air Passenger Carrier Market in Ukraine*, p. 4.

³⁵ European Commission, Developing a Common Aviation Area with Ukraine, Communication from the Commission, COM(2005) 451 final, Brussels, 27 September 2005

³⁶ European Commission, "EU and Ukraine Seal GALILEO and Aviation Agreement", press release IP/05/666, Brussels, 3 June 2005.

would help open markets on both sides and create benefits for aviation industries and consumers.³⁷

The above-mentioned developments are in line with the priorities defined in the EU-Ukraine Action Plan. Art. 49 of the chapter on Transport, Energy, Information Society and Environment includes the following selected measures and reforms in the aviation sector:

- Determine an effective model of negotiations on bilateral aviation agreements concluded with EU member states in order to include the Community designation clause, taking into account the horizontal mandate given to the Commission;
- Obtain full member status in the European Joint Aviation Authorities (JAA), and explore possibilities for arrangements in the field of aviation safety with a view to the stated Ukrainian objective to become a member of the European Aviation Safety Agency (EASA); and
- Cooperate on safety and security issues.

Ukraine should proceed with negotiations over air communications with the EU. At the same time, it should identify priorities for the development of the air transport sector. The short- and medium-term objective could be the transformation of Boryspil International Airport into a modern hub for Central and Eastern Europe. This would help take the advantage of Ukraine's geographical location. The reduction of legislative and administrative burdens through the adoption of the EU *acquis*, in particular on de-monopolisation of certain airport services, would help bring FDI to the sector.

3.4 Financial services³⁸

The process of developing financial services (banking sector, securities and insurance markets) in Ukraine has been in line with international standards.

Banking sector: Most of the provisions of pertinent EU directives on the banking sector (i.e. Directive 2000/12/EC) have been incorporated into Ukrainian law. However, the banking sector remains underdeveloped. The entry of foreign capital into the Ukrainian banking markets has been problematic. Only recently has the National Bank of Ukraine initiated the abolition of rules that prohibit foreign banks from opening branches in Ukraine. This will help liberalise the banking sector.

Insurance: The insurance market, although small, attracted foreign investors after the abolition of foreign ownership limitations. However, the insurance sector remains partially liberalised. The main EU requirements regarding licensing and supervision in the sector have been incorporated into the Ukrainian legislation. However, the most recent EU directives on insurance are conceived for the highly developed insurance markets of the EU member states. Therefore, Ukraine should seek conformity with international standards (e.g. Insurance Principles, Standards and Guidance Papers of the International Association of Insurance Supervisors and the 1997 Guidelines for Insurance Regulations and Supervision of the OECD Insurance Committee).

³⁷ European Commission, "The European Commission Proposes to Open Aviation Negotiations with Ukraine", press release IP/05/1190, Brussels, 27 September 2005.

³⁸ This sub-section draws heavily on O. Biryukov et al., "Financial Services: Securities, Insurance", Scoreboard Papers on approximation of Ukrainian legislation to the EU", *Ukrainian Law Review*, Issue 5/10, May 2004, Kyiv.

Securities: Market capitalisation in Ukraine remains the lowest among the European countries.³⁹ However, there has been significant progress in the development of securities markets legislation in Ukraine, as manifested in the introduction of depository systems and the establishment of a stock exchange. The legislation in this sphere however remains underdeveloped, in particular towards investment funds and joint investments.

Financial services were given special attention in the EU-Ukraine Action Plan. Emphasis was put on the implementation of the recommendations of the IMF's Financial Sector Assessment Programme (FSAP) of November 2003. The regulatory framework for financial markets and supervision equivalent to that existing in the EU should be introduced and effectively implemented. A number of draft laws regarding company, accounting and corporate governance rules must be adopted and implemented. The institutional component is also present – independent and well-trained supervisory authorities should be established in accordance with international standards.

The Ukrainian government identified conformity with IMF recommendations as a priority for 2005. These recommendations should help Ukraine to create a solid base for further integration with the EU, i.e. for starting talks on the liberalisation of trade in services. However, other prescriptions identified in the Action Plan should be given proper attention. On the one hand, the implementation of these prescriptions will create the conditions necessary for Ukraine to catch up with the European services-oriented economies. On the other hand, by opening up markets for services, Ukraine will create new opportunities for the provider of services and individuals, as well as better and cheaper services.

Box 3. Summary of recommendations in the IMF/WB FSAP Report

The main recommendations for promoting the stability and sound development of the Ukrainian financial system can be divided between those of immediate importance which are readily implementable, and those requiring more preparation.

Short term, readily implementable:

- Increase the minimum risk-weighted capital adequacy ratio for banks to at least 10% (as intended) and preferably eventually to 12%.
- Require banks through prudential supervision to limit foreign currency-denominated credits to borrowers without a reliable source of foreign currency earnings.
- Further strengthen supervisory controls on insider and connected lending; implement consolidated supervision.
- Maintain requirement that banks take prompt corrective action to rectify any prudential deficiency, and strictly avoid forbearance.
- Pursue vigorously the rehabilitation and restructuring of a major bank.
- Clarify to the public the prioritisation of the central bank's domestic and external monetary policy targets.
- Phase out the NBU's longer-term refinancing facility, or, at a minimum, strictly limit refinancing provided under the facility, and require that only high-quality collateral of matching maturity be provided.
- Make operational the new regulatory agency for non-bank financial institutions.
- Increase the size and concentration of the issues of domestic government debt.

³⁹ For more information, see World Bank *aide memoirs* on Corporate Governance Reform in Ukraine from 29 October 2002.

- Make operational the Financial Monetary Department (the financial intelligence unit).

Medium term, possibly requiring amendments to laws and regulations, or other extensive preparations:

- Review and revise provisioning rates based on empirical evidence of loss rates.
- Tighten regulations on bank equity investment.
- Require banks to prepare accounts fully in compliance with IAS (international accounting standards).
- Integrate the insurance of deposits at a major bank into the FGDNP system.
- Appropriately limit the conditions under which central bank management can be replaced; and determine central bank profit transfers to government on the basis of realised profits.
- Update and extend regulation for non-bank financial institutions, notably for leasing companies, pension funds and credit unions.
- Simplify auction procedures for government securities.
- Consolidate securities exchanges, registrars, and depositories; increase disclosure requirements.
- Modernise the mortgage law, land and building titling, and the law on secured transactions.
- Strengthen shareholder rights by increasing access to corporate information, moving towards international standards in corporate accounting and audit, facilitating shareholder control of management, and reinforcing supervisory boards (including of banks).
- Update and extend anti-money laundering regulations, for example, on recognising unusual or suspicious transactions.

To conclude this section, the inclusion of services into an EU-Ukraine free trade agreement would bring benefits to both sides. The providers of services from the EU member states will get access to Ukraine's markets with its almost 50 million inhabitants. Ukraine will first of all improve its economic governance system through the acceptance of EU standards and international standards. At the same time, it will also get access to the EU's markets, albeit with significant restrictions, as the example of other third countries shows.

The experience of EFTA countries with their full compliance with the EU *acquis* is not applicable for Ukraine, given the high costs of full compliance. However, the experience of Switzerland is useful and could be applied after the implementation of a number of reforms. The cases of Turkey and MEDA countries are also helpful. The former is seeking to stretch the Customs Union to services (and agriculture); and the latter is seeking to add a 'liberalisation of trade in services' to the existing FTAs with the EU. By so doing, these countries will tackle two problems. They will receive access to EU services markets and they will be able to modify their economic governance systems. This, of course, requires a synergy between policy actions described in section 2.3. In the case of Turkey, assistance will be provided through the pre-accession funds, and the compliance with the EU *acquis* will be treated as a pre-accession commitment.

Ukraine should consider the inclusion of services sectors in its free trade agreement with the EU, as it will bring benefits to Ukraine. However, the Ukrainian government should bear in mind the costs of compliance on the one hand, and on the other hand, should seek to find the balance between liberalisation of services sectors and protection of domestic services providers.

4. Interest Groups: Who are they? Why and how to deal with them?

European lobbying groups constitute an indispensable part of national and international decision-making today. They employ available resources to influence policies at the national

and EU level. Since the delegation of policy-making authority to the supranational level, European interest groups have redirected their attention to the EU level. As the Commission has the power to initiate policy (especially in the sphere of the Internal Market), EU interest groups seek to influence the decision-making process through, for example, the consultation process with the Commission.

High politics was the strongest force both behind the CEECs' desire to join the EU, as well as the EU's decision to enlarge. However, low politics influenced the duration of the integration process. European business interests succeeded in imposing conditions favourable to them (through, for example, transition periods). The influence that low politics can have is similarly evident in EU-African countries' relations where EU politicians declare poverty relief strategies while some European companies are lobbying for trade concessions to the detriment of the third countries.

In view of the uncertainty of EU-Ukraine relations in terms of high politics, low politics might have much more influence over EU policy towards Ukraine, especially on trade issues. If Ukraine seeks deeper integration with the EU, especially regarding access to the Internal Market, the national political elite should have a clear understanding of EU lobbying groups, the various options, channels and routes for influencing European policy-making and the threats that these groups may constitute for Ukraine (especially during the negotiations of the FTA between the EU and Ukraine).

4.1 The European Union⁴⁰

The EU member states have different opinions on Ukraine's further integration with the EU, since some of them would prefer to protect their metallurgical, chemical and agricultural producers from respective Ukrainian exports. Certainly not all European companies are keen to allow the access of Ukrainian goods to EU markets. First of all, large producers of agricultural goods from France, Spain and Italy have concerns about Ukrainian exports of agricultural commodities and food.⁴¹ Similar concerns exist among the European producers of ferrous metals and chemicals (however, the list of interested countries is somewhat different and includes Germany and France).

Lobbying in Europe has a long history; therefore it is useful to consider different types of lobbying groups active in the EU. The first group consists of umbrella organisations, the so-called Euro-federations that comprise of national business associations. Among the most famous are the European Federation of Pharmaceutical Industry Associations, the EuroCommerce (the main organisation representing retail and distribution), and the COMITEXTIL (the coordinating body of national textile federations). However, these Euro-federations are losing their lobbying powers. They are less effective in lobbying on behalf of their members.⁴²

Therefore a new formula of collective representation and promotion of business interests is entering the stage in EU policy-making. This type of lobbying requires direct membership of some sort of Euro-association of companies. Among them are the EU Committee of the American Chamber of Commerce in Belgium, the Association of European Automobile

⁴⁰ This section on EU interest groups draws on B. Pijenburg, "EU Lobbying by Ad Hoc Coalitions: An Exploratory Case Study", *Journal of European Public Policy*, Vol. 2, No.5, June 1998, pp. 303–21.

⁴¹ Although it also produces agricultural products for the EU, Poland has a political interest in supporting Ukraine in the Union.

⁴² Pijenburg, op. cit.

Constructors, the European Round Table (ERT) of Industrialists, the European Information Technology (IT) Round Table and the Association for the Monetary Union of Europe. Some Euro-federations, such as the Union of Industrial and Employers' Confederations of Europe (UNICE) and the Conseil Européen des Fédérations de l'Industrie Chimique (CEFIC), offer their membership to a number of large individual companies.

Given that the two types of lobbying groups described above have seen their influence declining in recent years, they might not constitute enormous threats for Ukraine. Moreover, some pro-integration Euro-federation lobbies might support deeper integration of Ukraine with the EU and offer assistance and cooperation. The idea of the European Round Table of Industrialists to focus on moving towards an 'Integrated Economic Region' (EIR) in the ENP deserves the attention of the Ukrainian government. The ETR's proposal emphasises the importance of intra-regional cooperation and of neighbours' opinions, which should be considered in the drafting of the Internal Market rules. It was also pointed out that the approach regarding EU technical assistance (TA) should be changed – the assistance should be adjusted in view of the needs of a recipient country.

Some of these recommendations are not new. The Ukrainian side approached the Commission with the request to provide the type of assistance similar to that received by candidate countries. These baselines for TA have also been reflected in the ENP and the AP. However, there are also supporters of Ukraine's position among European business groups. Moreover, groups such as the ERT may offer support to the governments and businesses of the neighbouring countries by providing specific recommendations and assisting in the creation of Business Advisory Councils, respectively.

A further collective lobbying group at EU level is the 'ad hoc coalition' of large companies. These coalitions are more flexible in their activities, as their partners enjoy greater autonomy and the decision-making process is more informal. By being limited to a single-issue profile, they prove to be more effective in defending their common interests and using their resources to lobby the European institutions. Many large EU companies keep permanent contacts with the Commission and other EU institutions through their offices in Brussels or by sending their staff members on secondment to the Commission. Business representatives participate in the different advisory committees in the Commission and the technical bodies concerned with EU standards in accordance with the Commission's consultation procedures.⁴³

It is therefore more likely that ad hoc coalitions formed by European companies and/or large individual companies may oppose favourable trade conditions for Ukraine in the negotiations of the FTA. These obstacles could be overcome if the Ukrainian business lobbies were to create their own alliances and seek European partners with similar interests/positions.

Forming ad hoc lobbying coalitions may also be useful for Ukrainian lobby groups. Although some Ukrainian companies have already established links with Brussels, their relations with the European institutions have not yet been institutionalised. At the same time Ukrainian companies may learn from the experience of large Japanese and US companies; because these companies are almost excluded from the various collective fora at the EU level, they seek out 'alliances with European firms to enhance their position in the European policy debate'.⁴⁴

⁴³ For more information on the Commission's consultation procedures, see European Commission, *Towards a Reinforced Culture of Consultation and Dialogue: General Principles and Minimum Standards for Consultation of Interested Parties by the Commission*, Communication from the Commission, COM(2002) 704 final, Brussels, 11 December 2002.

⁴⁴ Pijnenburg, *op. cit.*

Finally, large individual companies may also constitute powerful interest groups. Companies like Volkswagen and Fiat proved to be extremely influential during the negotiations of the Accession Agreements with the CEECs ensuring that transition periods would secure their interests in the new member states (i.e. investment tax concessions). Large foreign companies could also pose a threat to Ukrainian interests. Although they usually bring both capital and technology to the country, they impose conditions on the national government that might be detrimental to national interests. This is not to say that MNCs should be prevented from entering Ukrainian markets. However, their ability to exert pressure should be taken into account by the Ukrainian government.

To sum up, Ukrainian business lobbies may use the experience of their European counterparts in a number of ways. In order to lobby effectively at the EU level, Ukrainian companies should attempt to join ad hoc alliances of European companies, initiate ad hoc alliances with European companies of similar interest and open up their own offices in Brussels.

Moreover, in order to institutionalise the participation of Ukrainian companies in the policy-making process at the national level, these companies should press the government to establish transparent rules of the game. By so doing they may be able to pressure the government into creating clear and comprehensive consultation procedures. They can insist on the creation of a government body (agency or department within a ministry) responsible for consultations with independent regulators, associations, business groups and other interest groups (e.g. the Department of Trade and Industry in the UK is responsible for consultations on the EU Services Directive). At the same time they may assist the government in the creation of a Business Advisory Committee(s).

4.2 Ukraine

Lobbying in Ukraine is a relatively new type of activity, if lobbying here is understood according to Western European tradition. Old Ukrainian power favoured non-transparent policy-making, taking into account the interests of only a few leading business groups. The remaining interest groups were considered illegitimate. Although some procedures for consultations with the government did exist, actual implementation of these instruments was rare or delayed.

At the time of writing, two general types of national interest groups can be defined as current/potential obstacles to Ukraine's deeper integration with the EU. These are the sectoral lobbying groups and the politicians-populists.

The sectoral lobbying groups represent companies in sensitive sectors of the Ukrainian economy – ferrous metallurgy, agriculture, textile, car manufacturing, iron and steel. The metallurgical companies represent the most powerful lobby in the Ukrainian Parliament. Their recent pressure on the Parliament became apparent through the establishment of price control on raw metal. Such a regulation of the metal market remains problematic for the negotiations between the EU and Ukraine on the country's status as a market economy. The introduction of an export duty on scrap metal is also a result of the metallurgists' lobbying activities. This duty poses a serious problem for Ukraine's negotiations on WTO accession.

Nonetheless, the Ukrainian metallurgists seek more access to EU markets. Hence, they are interested in the country's accession to the WTO and the creation of a free trade area with the EU. In their view the national government is not capable of lobbying their interests at EU level. They thus seek other channels, which enable them to participate in EU markets. The only possible channel to date, however, is to purchase metallurgical plants in the new EU member states.

A further powerful sectoral group are the car manufacturers, who already created obstacles for Ukraine's deeper integration with the West, i.e. the WTO and the EU. The car-manufacturing sector is highly protected by regulations. The results of their lobbying activities are reflected in the highly protective Law on Changes and Amendments to the Legislation on State Support to Car Manufacturing Sector in Ukraine. However, such protectionist policy may hamper the development of the sector and hinder effective competition. The companies of this group have already established contacts to Brussels through meetings with Commission representatives and European business circles⁴⁵ However, their communication has not yet been institutionalised.

On the whole, the Ukrainian agricultural lobby does not constitute an obstacle to the country's integration with the EU. The Ukrainian agricultural sector remains cumbersome. The reform of the sector is inevitable. Although the *acquis* provides neither a template for reform nor does it define the sequencing of harmonisation, it remains the best available set of rules and standards so far. Therefore, the convergence on EU standards will assist the implementation of the reforms.

However, conflict within the sector – between the producers and exporters of sunflower seeds – still poses a problem for deeper integration with the West. The former group prefers the export duty to stay high, whereas the latter is interested in greater access to world markets and therefore for export duties to be close to zero.

To conclude, the opinion of sectoral lobby groups should not be neglected or suppressed during the negotiations on WTO accession or the conditions of the FTA with the EU. By following the rules and procedures of the previous regime, the government faces constant confrontation with the affected interest groups. These groups should instead be brought into the discussions on the proposed policy options or the actual negotiations. Their opinion should be taken into account, analysed and if relevant, included in the policy proposal or legislation. However, such an inclusive consultation process requires the establishment of the appropriate procedures within the government. If such procedures exist they should be followed.

There are no unified standards and procedures for consultations with interest groups that are binding for all EU member states. However, there are good practices at the Commission's level and within individual EU member states. The experience of the UK's Department of Trade and Industry in conducting consultations with interest groups on the Commission's Proposal for the Services Directives is worth mentioning.⁴⁶

The politicians-populists constitute a second type of interest group, who lobby against Ukraine's integration with the EU. They pose a threat to the development of the Ukrainian economy. By covering themselves with slogans in support of national producers and national markets, they hamper the country's progress towards deeper integration with the West. In general, these politicians may not actually be against WTO accession or the establishment of a free trade area with the EU. However, they use their voting power to pursue their own ends. The populists⁴⁷ voted against or refrained from voting for the draft laws that needed to be passed for the country to accede to the WTO. Their intentions are clear as they seek to gain the voters' support on the eve of the parliamentary elections in 2006.

Populists exist in every society. However, the government should try to find ways to thwart such politicians, as the development of Ukraine's economy can only be achieved through

⁴⁵ Meeting with a representative of DG Trade, European Commission, 11 July 2005.

⁴⁶ For more information, see <http://www.dti.gov.uk/ccp/topics2/servicesdirective.htm>.

⁴⁷ Reference is to representatives of the opposition in the Parliament: the Communist Party of Ukraine, Social Democrats United, etc.

opening up the national market to Europe and the world. In order to do so, the government needs to support itself with proper statistical and analytical materials. Western-type consultations will provide the government with information about who is against/for the proposed policy and enable them to develop strong arguments for the proposed policy.

It can only be hoped that the Orange Revolution and the changes in the presidential administration and the government will lead to the introduction of clear and transparent rules of the game. However, a mere understanding of the need to be transparent is not enough nor is the existence of procedures. Thus, in order to establish an efficient policy-making process, the political elite needs to follow the rules and procedures outlined above.

4.3 'The Russian factor'

With regard to EU-Ukraine cooperation and the influence of interested parties, it is worth touching upon the 'Russian factor'. First of all, Russia constitutes a threat to Ukraine's membership in the WTO. If Russia accedes prior to Ukraine, there is a risk that Russia will make additional demands on Ukraine.

Moreover, Russia nurtures the idea of a Single Economic Space (SES) to be created among the CIS. The initial steps for its creation have already been taken. However, the participation of Ukraine in this venture may not be beneficial, and could be harmful, if the SES goes beyond the free trade area. This issue requires both the economic and legal assessment of Ukrainian experts.

At the same time, Ukraine's desire to create a free trade area with the EU may be subject to Russian opposition. A natural solution to this problem would be the alternation of governments in France and Germany. The new governments might feel less obliged to support Russian interests in all cases and instead purely consider EU and Ukrainian interests, respectively. This, however, is not to say that Russia should become a less important partner for Ukraine.

5. Towards the EU Single Market: Policy Options

Economic theory shows that participation in a free trade area is beneficial for the economy of a developing country if certain conditions are met. For the EU, an FTA is a means of increasing economic integration through improved access to the EU Internal Market, which is seen as important in achieving other political, foreign policy and security objectives. A key element of the EU's free trade agreements is the extent to which they deliver improved market access.⁴⁸

The creation of a free trade area between the EU and Ukraine is envisaged by Art. 4 of the PCA. A 1999 study on the economic feasibility of a free trade agreement between the EU and Ukraine concluded that it would be beneficial for Ukraine. It would enable the country to liberalise trade, give impetus to FDI, and help reach production efficiency. On the other hand, an FTA would not cause serious disruptions for EU markets due to the resource-oriented structure of Ukraine's exports.

Thus, the initial conditions for an EU-Ukraine FTA are reasonably favourable. The new government is committed to comprehensive reform. For the first time in EU-Ukraine relations, the EU offered a number of direct 'prescriptions', the implementation of which will lead to deeper integration (or a suspension of cooperation). The Action Plan foresees measures that will help Ukraine lock-in domestic reforms, lower the risk premium and become an open economy. The main task is to implement the 'prescriptions' given.

⁴⁸ P. Brenton, *Making EU Trade Agreements Work: The Role of Rules of Origin*, CEPS Working Document No.183, CEPS Brussels, March 2002, p. 7.

EU relations with third countries or groups of countries are the result of several decades of negotiations and cooperation agreements. The available trade agreements range from the Free Trade Agreements, to Customs Unions and Common Markets. There are, thus, lessons to be drawn from this experience as to the future integration between the EU and Ukraine. The comparison of European economic integration with a system of concentric circles would be appropriate. The system of concentric circles envisions that the countries in the inner circles are more deeply integrated than those in the outer circles.⁴⁹

The analysis will go from the low degree of integration, i.e. an FTA with the Mediterranean countries, to the deepest degree, i.e. the European Economic Area (See Annex 3 for an outline of the scope of the EEA). By looking at the above-mentioned options in more detail the paper will identify the coverage of the agreements; the degree of compliance with the *acquis* that is required/envisaged; the main measures that should be taken by a country to ensure the planned harmonisation; the main deficiencies of the agreements and the subsequent difficulties that arise. Each option will be assessed in terms of the costs of compliance and the trade-off between national sovereignty (i.e. national policy discretion) and influence on the EU's 'rules of the game'. Special attention will be paid to the EU-Swiss model of cooperation, as it seems to be a reasonable model for EU-Ukraine cooperation in a long-term perspective. A general conclusion will be made as to how effective a particular option is in terms of ensuring access to the Internal Market.

5.1 Euro-Mediterranean Free Trade Area

The free trade agreements between the EU and Mediterranean countries present a fourth ring of the system of concentric circles. This ring is the most distant from the hardcore EU member states, which are fully integrated into an Internal Market. The FTA with the Mediterranean countries is an example of a classic FTA. This type of agreement envisions the elimination of barriers to trade in goods among members with the preservation of the freedom of each member to maintain different external tariffs with non-members. However, it does not provide for the extension of the Pan-European Rules of Origin to the Mediterranean countries. Moreover, the arrangement excludes the free trade in services, which could provide more possibilities to the Mediterranean countries. Given that the adoption of the *acquis* is legally binding in a small number of areas, the Mediterranean countries cannot have full access to the EU's Internal Market.

Table 3. Euro-Mediterranean Free Trade Areas

Legal base	The Association Agreements* of the 1990s, which replaced the Cooperation Agreements (with their non-reciprocal preferences), European Neighbourhood Policy
Coverage	The agreements go beyond free trade by covering a wide range of trade-related matters such as a regulatory framework for trade, capital flows, property rights, disputes settlement and technical assistance.
Degree of harmonisation	Harmonisation was not legally binding until the creation of the ENP Action Plans. Since then harmonisation must be ensured in a number of spheres.
Measures of deeper	With the goal changing from free trade towards deeper integration, EU foreign ministers decided to launch the EuroMed Internal Market Programme (April 2002, Valencia). The Action Plan aims to harmonise the Mediterranean countries

⁴⁹ D. Muller-Jentsch, *Deeper Integration and Trade in Services in the Euro-Mediterranean Region: Southern Dimensions of the European Neighbourhood Policy* World Bank/European Commission, Brussels 2004, p. 10.

integration	legislation with EU norms and standards.
Trade	The agreements envision the creation of a Mediterranean-wide free trade area in two stages: 1) the conclusion of eight bilateral FTAs with the EU together with customs union agreements with Turkey, Cyprus and Malta; 2) sub-regional agreements between the partner countries (e.g. Morocco, Tunisia, Egypt and Jordan). The agreement foresees free trade in manufactured goods and progressive liberalisation of trade in agricultural products.
Costs of compliance	The costs of compliance are high taking into account the extensive list of harmonisation tasks. However, the EU covers part of the costs through the MEDA programme ⁵⁰ (and European Neighbourhood and Partnership Instrument in the future ⁵¹).
Scope for national policy discretion	Discretion is rather limited since the adoption of the Action Plan.
Scope to influence the 'rules of the game'	Mediterranean countries have no influence over EU policy-making; the capacity for policy shaping is absent.
Effectiveness in terms of market access	The countries have free access for manufactured goods and agricultural products (limited).

*For detailed information on the structure of EU free trade agreements with selected developing countries, see Annex 4.

Source: Extracted from M. McQueen, "The EU's Free-Trade Agreements with Developing Countries: A case of Wishful Thinking", *World Economy*, 25/10 pp. 1531-1533/4.

5.1.1 Lessons for Ukraine

It is quite challenging to draw conclusions regarding the implications of the FTA between the EU and Mediterranean countries since the project has been launched only recently. The free trade area is still to be accomplished by 2010. Most of the conclusions are static as they are based on theoretical assessments in the absence of empirical data.

(?) First of all it is worth looking at the rationale behind the EU's involvement in the region. The EU has been faced with an urgent need to support peace and stability in the region in order to reduce illegal migration from the Mediterranean countries and to ensure the security of the member states. Since the unilateral preferences have failed to stimulate growth and development in the region, the Mediterranean-wide free trade area was initiated as an alternative. Cooperation that is driven by security concerns usually leads to greater involvement on the part of the EU. The example of the Balkans is revealing. Ukraine does not constitute a security threat for the

⁵⁰ MEDA is the EU's principal financial instrument for the implementation of the Euro-Mediterranean Partnership. The programme offers technical and financial support measures to accompany the reform of economic and social structures in the Mediterranean partner countries. DG EuropAid manages MEDA projects.

⁵¹ As regards financial assistance, a European Neighbourhood and Partnership Instrument (ENPI) will from 2007 onwards replace the current TACIS and MEDA programmes in the ENP partner countries and Russia.

EU; therefore it is difficult to expect similar attention. However, “precedents set in one FTA might shape later FTAs”.⁵²

(–) The FTAs with Mediterranean countries are “broad in coverage but shallow in depth on trade-related issues”.⁵³ They impose the EU’s terms and conditions for trade and limit or refuse preferences for sensitive agricultural and fisheries products, although consultations aimed at future liberalisation are envisioned by the agreements. Ukrainian goods are in a similar position now. However, the inclusion of Ukrainian agricultural products should not create disruptions on EU markets. Therefore Ukraine may be able to insist on the inclusion of these products.

(+) The FTAs might have a confidence-building effect for foreign investors, since they include measures for additional protection, for example through clauses on intellectual property rights, the extension of EU competition and regulation to trade-related transactions and the disputes settlement procedures. For the effect to manifest itself, it is important for the agreements to be fully implemented. If the implementation of measures is not legally binding (e.g. under the PCA), it will suffer from lack of proper attention. Moreover, the European agreements are not a panacea for domestic reform. The commitment to reform by the national government is a precondition for success.

(–) The FTA with Mediterranean countries does not include the possibility of liberalising trade in services. However, the example of the Mediterranean countries (e.g. Jordan) with regard to initiating the expansion of the FTA on services is important for Ukraine.⁵⁴ Ukraine should not wait until the FTA (or any other type of agreement) is signed with the EU.

(+) If the Euro-Med Internal Market programme were implemented as planned, the potential gains from such integration would be substantial. The estimation of McQueen’s study reveals that a deeper agreement, eliminating non-tariff barriers (red tape and standard-related costs) on an MFN basis, would generate gains estimated at 4% of real GDP.⁵⁵ The participation of Ukraine in a Euro-Med Internal Market-type of endeavour would be beneficial to Ukraine. However, this option does not seem feasible for the country as Ukraine’s direct neighbourhood is not homogenous.

(+) The effects of the EU-Mediterranean FTA will be significant for the development of regional trade and, hence, for regional integration. As in the case of the EFTA states, Ukraine needs partners with similar levels of economic development, aspirations and goals. In the absence of such similarities, this option is not feasible for Ukraine.

(–+) The highly restrictive rules of origin pose a problem for the exports of the Mediterranean countries. The EU seeks to mitigate the effects of the rules “by allowing a partner country to count imports from the EU of intermediate products used in production as ‘originating products’ (bilateral accumulation)”.⁵⁶ Moreover, groups of developing countries are allowed to have regional cumulation of origin (e.g. Morocco-Algeria-Tunisia). The full cumulation of origin is envisioned in the Euro-Med free trade area with compulsory adoption of EU rules. Ukraine could use the first and the second options. In the absence of regional free trade arrangements, the third option is not feasible.

⁵² M. Emerson, M. Vahl and S. Woolcock, *Navigating by the Stars: Norway, the European Economic Area and the European Union*, CEPS Paperbook, CEPS, Brussels 2002, p. 25.

⁵³ McQueen, op. cit.

⁵⁴ S. Jones and M. Emerson, *European Neighbourhood Policy in the Mashreq Countries: Enhancing Prospects for Reform*, CEPS Working Document No. 229 CEPS, Brussels, September 2005, p. 32.

⁵⁵ McQueen, op. cit.

⁵⁶ McQueen, op. cit.

(→) The Mediterranean countries have no right to influence the EU decision-making process. Even the creation of the Euro-Med free trade area will not shift the balance. However, the countries might receive some degree of decision-shaping capacity through participation in the Commission's working groups. Ukraine will probably receive no right to influence the EU's decision-making process in any future EU-Ukraine agreements. However, it may seek decision-shaping capacity, in a similar way to its Mediterranean partners.

5.2 EU-Turkey Customs Union

EU-Turkey cooperation in the framework of the Customs Union belongs to the third ring of the system of concentric circles. Turkey is the only candidate country that has such an arrangement with the Union. This arrangement foresees the establishment of a common external tariff on all trading sectors and all members, in addition to the elimination of barriers to trade between them. It is advantageous for the removal of the norms and procedures of the rules of origin on products that come from third countries and are traded by the EU and Turkey. However, the scope of the Customs Union remains quite narrow as it covers trade in goods only. Recent studies on the effectiveness of the Customs Union revealed that Turkey has been losing because of the exclusion of services from the arrangement. Therefore, Turkey and the EU should seek ways to extend the Customs Union to service sectors prior to the country's accession.

Table 4. EU-Turkey Customs Union⁵⁷

Legal base	The customs union agreement of 1995 between the EU and Turkey.
Coverage	The customs union is not restricted to conventional border controls; it goes beyond by covering areas of deep integration.
Degree of harmonisation	The agreement foresees approximation towards the <i>acquis</i> (especially regarding industrial goods) with the exception of agriculture, services or public procurement. Substantial overall liberalisation, the external liberalisation of tariff regimes and a significant alignment of regulatory structures (technical barriers to trade, competition policy, customs administration and intellectual property rights) have been achieved.
Measures of integration	<i>Traditional:</i> The elimination of customs duties and charges and the harmonisation of external tariffs for industrial products towards the non-participants of the EU's Common External Tariff (CET). <i>Non-traditional:</i> The adoption of EU customs provisions in the field of origin of goods, customs valuation of goods, introduction of goods into the territory of the customs union, customs declaration, release of goods for free circulation, suspensive arrangements and movement of goods. <i>Deeper integration:</i> The incorporation of all Community instruments dealing with the removal of TBTs. The adoption of rules concerning the protection of competition (competition discipline and state aid to industry). The adoption of rules concerning protection of intellectual, industrial and commercial property rights under the TRIPS agreement.
Trade	The tariffs against Turkey had been gradually reduced by the EU in 1970s and 1980s; hence, free trade with the EU was possible prior to the customs union arrangements. Tariff barriers only remained for some sensitive products. Turkey shadowed the free trade agreements negotiated by the EU with EFTA, Israel, Romania, Bulgaria, the Balkans and the Mediterranean countries.

⁵⁷ This table on the EU-Turkey Customs Union draws heavily on S. Ulgen and Y. Zahariadis, *The Future of Turkish-EU Trade Relations*, CEPS EU-Turkey Working Document No. 5, CEPS, Brussels, August 2004.

Costs of compliance	The costs are high if one considers the broad scope of the agreement and the absence of any leeway in the sequencing of reforms. The costs are partially covered by the EU's technical assistance programmes. ⁵⁸
Scope for national policy discretion	Turkey has no right to opt out.
Scope to influence the 'rules of the game'	Turkey has no influence over EU decision-making or policy-shaping.
Effectiveness in terms of market access	The access is moderate (restricted to free movement of goods) due to the continuing use of TBTs, defence and safeguards measures against Turkish exports.

5.2.1 Lessons for Ukraine

(+) Turkey was (and remains) an economically less developed country than the ETFA states. Therefore the customs union had certain developmental impacts on the country's economy. Through the customs union Turkey was forced to liberalise its foreign trade (the external tariff rate of protection was much higher than that of the EU). This gave Turkey an impetus to introduce stronger competition, which led to the transformation of Turkish industry and the improvement of productivity. This, in turn, has contributed to the modernisation of Turkey's economic legislation and, hence, the business environment. A broadly framed customs union agreement could help to lock-in reforms and to encourage further transformation in Ukraine.

(-) From a political perspective, the probability of the creation of a customs union between the EU and Ukraine is low. Turkey was already a candidate country when the customs union agreement was negotiated.

(+/-) The compliance costs incurred by Turkey seem reasonable. The list of EU prescriptions in the EU-Ukraine Action Plan is similar to the customs union agreement. However, Turkey receives the technical assistance (TA) assigned to candidate countries – which differs from the TA assigned and envisioned for Ukraine, both in scope and approach. If the European Neighbourhood and Partnership Instrument is being developed in accordance with PHARE and if the volume of financing is increased, then this option would be beneficial for Ukraine. A study on the economic feasibility, implications and costs of a prospective customs union between the EU and Ukraine would be an interesting direction for further research.

(-) Although the customs union envisions a common commercial policy, Turkey's influence on the rules of the game is close to zero. The negative implications for Turkey's position are striking. Unilateral decision-making by the EU is also evident in the trade agreements negotiated with the CEECs. Ukraine should thus be cautious of the EU's dominant position in negotiations.

⁵⁸ Until 2002, Turkey had received support under the MEDA programme and through two regulations to support the customs union and economic and social development. For the period until 1999 the key aim of assistance to Turkey had been to accompany the process of structural reform, as for other Mediterranean partners. Following the Helsinki European Council in 1999, a pre-accession orientation was introduced to the financial assistance programmes with Turkey. Assistance continued to be available for structural adjustment, in co-ordination with international financial institutions, but assistance also began to focus on institution building, investment, and supporting the participation of Turkey in Community programmes and agencies.

(–) The scope of the customs union is restricted to the free movement of goods only. The exclusion of such important areas as agriculture, services and public procurement undermines Turkey's position, hindering full access to the EU's Internal Market. Recently, Turkey started discussions about the possibility of an agreement on trade in services. The promise of membership may be a 'press-down' factor for the EU to move towards the liberalisation of trade in services with Turkey. In the case of Ukraine, it is important to insist on the inclusion of a clause on the liberalisation of services parallel to the liberalisation of trade in goods in any future agreement with the EU.

5.3 EU-Swiss bilateral cooperation

Given that membership is not on offer to Ukraine in the short or medium term, it would be worth paying special attention to the model of cooperation between the EU and Switzerland. This model allows the latter to choose the sectors in which to comply, hence, in which to have access to the EU's Internal Market.

The relationship between the EU and Switzerland presents a more advanced package in comparison to the EU-Turkey Customs Union, whereas on the other hand, it is a less comprehensive arrangement in terms of sector coverage than that of the European Economic Area between the EU and the EFTA countries. Switzerland has access to the EU Internal Market in those sectors in which it has full compliance with the EU.

In 1972, Switzerland signed a free trade agreement with the EEC. It abolished tariff-based trade restrictions on industrial goods between the two parties. It ensured that Switzerland was not left entirely out of the EC integration process. On the other hand, the agreement did not require giving up the country's sovereignty, and also allowed Switzerland to negotiate additional trade agreements.⁵⁹ The country concluded over 100 special bilateral treaties with the EC, most of which involved trade in goods. At the same time, the EU and Switzerland conducted negotiations on other key policy areas, such as transport, environment, research and development.

The 'sector-specific agreements', or in other words, Bilateral Agreements I between Switzerland and the EU concluded and signed in 1999 covered seven specific areas:

- the free movement of persons,
- the elimination of technical barriers to trade,
- public procurement markets,
- civil aviation,
- overland transport,
- agriculture, and
- research.

These agreements form the basis of a contract enabling Swiss companies to operate within the Internal European Market subject to practically the same conditions as their EU competitors in the seven sectors concerned. They ensure a reciprocal opening of markets in a progressive and controlled manner.⁶⁰

⁵⁹ Integration Office DFA/DEA, *Stages of Swiss European Policy*, Integration Office DFA/DEA, Bern, September 2005 (available at www.europa.admin.ch.)

⁶⁰ Integration Office DFA/DEA, *Bilateral Agreements I between Switzerland and the European Union of 1999*, Integration Office DFA/DEA, Bern 2004 (available at www.europa.admin.ch).

From June 2002, the negotiations between Switzerland and the EU were extended to 10 other dossiers, e.g. the food industry, the financial centre, tourism, domestic security and asylum policy (Schengen/Dublin), environment, statistics, culture and training. In March 2003, the EU and Switzerland also negotiated the liberalisation of services.

Box 4. The benefits of the Bilateral Agreements for Switzerland

1. Agreements cover significant economic interests:

Financial sector: protection of interests of the Swiss financial sector (taxation of savings, fight against fraud), and the preservation of banking confidentiality in relation to direct taxation (Schengen/Dublin)

Food industry: reduced customs duties improve export opportunities for the food industry. This also benefits Swiss agriculture as a supplier (processed agricultural products)

Tax benefits for holdings: Swiss holdings operating throughout Europe pay less tax (taxation of savings)

2. Extension of cooperation to other important political areas:

Security policy: fight against cross-border crime by means of international policy and judicial cooperation

Asylum policy: the Dublin cooperation offers measures against ‘asylum tourism’ and thus relieves pressure on the national asylum system

Environment: by being a member of the European Environmental Agency, Switzerland contributes towards the European and international cooperation on protection of the environment

Statistics: the statistical agreement harmonises and optimises the exchange of comparable statistical data between Switzerland and the EU, hence key political and economic decisions are supported by broad-based statistical information

Culture: participation in the EU film promotion programmes (MEDIA) strengthens the role of film as an important part of Swiss cultural heritage

Education: cooperation within EU training programmes provides access to a wide range of training for Swiss nationals, and increases the quality of training. This provides improved opportunities in the employment market

Source: Integration Office DFA/DEA, *Bilateral Agreements I*, Bern.

In accordance with EU-Swiss agreements, the country can be selective in the adoption of the EU *acquis*. Hence, it can opt out from the adoption of the *acquis* and secondary legislation in a number of sensitive sectors. However, the EU-Swiss arrangement does not envision the participation of the latter in the EU policy-making process, which makes it almost impossible to influence the rules of the game. Problems related to rules of origin are solved by the bilateral agreements between the EU and Switzerland. By and large such type of arrangement is applicable only to a self-sufficient country with a high level of economic and political development, such as Switzerland. Nonetheless, the latter seeks deeper integration with the EU through its participation in different programmes and policies of the Union.

Table 5. EU-Switzerland trade relations

Legal base	The economic relationship between Switzerland and the EU is based on the 1972 free trade agreement, supplemented by a number of bilateral accords in different sectors (including an agreement on technical barriers to trade).
Coverage	Coverage is comprehensive with Switzerland's right to be selective in the adoption of the EU <i>acquis</i> .
Degree of harmonisation	Where Swiss product legislation is equivalent to EU legislation, a single test of conformity is used for selling a product in both Switzerland and the EU. In cases of divergence between Swiss and EU specification, further testing remains necessary. Other existing agreements aim to improve conditions for trade in certain agricultural products and expand access to public procurement markets. In 2001, Switzerland opened new bilateral negotiations on nine further subjects, including trade in processed agricultural products. These negotiations were concluded in May 2004.
Costs of compliance	The relative similarity of approaches to market regulation between Switzerland and the EU means that the costs of compliance are similar to those of the EU. Moreover, being a developed economy Switzerland does not face the need to increase its administrative capacity and modernise the economy (in contrast to Turkey or CEE countries).
Scope for national policy discretion	The agreement allows Switzerland to opt out from certain directives and regulations in sensitive sectors (i.e. investment and public procurement) or from those affecting the country's national interest. The control over sensitive sectors can be retained insofar as these are not covered by the OECD or GATs provisions. However, it must adopt the full <i>acquis</i> to guarantee market access.
Scope to influence the 'rules of the game'	Switzerland has no influence over EU decision-making.
Effectiveness in terms of market access	Moderate access only assured when Switzerland mirrors EU regulations. If Switzerland fails to comply with the EU <i>acquis</i> it can face suspension of benefits and, hence, access to the market.

Sources: This table on EU-Switzerland trade relations draws heavily on Emerson et al., Navigating by the Stars, CEPS, 2002, and European Commission, EU Relations with Switzerland: A Special Case, Brussels, October 2004.

5.3.1 Lessons for Ukraine

(+−) The selective approach is a double-edged sword. On the one hand, Switzerland has a right to opt out from the *acquis* in sensitive sectors. On the other, the EU itself might oppose negotiations in certain sectors that are not in the EU's interest. Moreover, the EU introduced the so-called 'guillotine clause' with regard to Switzerland, which entails the suspension of all seven bilateral agreements if Switzerland chooses to opt out from one of them. The selective approach would be beneficial to Ukraine taking into account the number of sensitive sectors and the costs of compliance. However, the example of Switzerland reveals that the EU protects its interests even in relations with highly developed countries at the heart of Europe. This is a clear signal to Ukraine that the selective approach may be constrained by a kind of guillotine.

(−) As the free trade area does not automatically lead to the acceptance of a common competition policy, a number of Swiss products remain subject to trade defence measures (i.e. anti-dumping). This in turn decreases the benefits of the EU-Swiss FTA.

(+) Rules of origin are defined by a special agreement with the EU providing that goods originating in Switzerland (and Norway) shall be treated on their arrival on the customs territory

of the Community as goods with content of Community origin.⁶¹ Ukraine could consider this option as a long-term alternative to joining the European cumulation system.

(+) The mutual recognition problem is partially solved through the additional bilateral accords. This was made possible due to the relative convergence of Swiss product legislation with that of the EU. Ukraine could consider this option, but only after the substantial harmonisation of Ukrainian with European standards. This is thus only viable in the long term.

(-+) Switzerland has no influence on the rules of the game. The country could have a policy-shaping capacity, but is constrained by domestic opposition to any further integration with the EU. This opposition prevented Switzerland from becoming an EEA member. However, this might change with the Swiss inclusion into the Schengen accords. This example is not instructive for Ukraine since the latter is seeking full EU membership in the long term. If there is a trade-off to be made between influence on EU policy-making and national policy sovereignty, the former is more desirable for Ukraine.

5.4 EFTA-EU European Economic Area

The cooperation between the EU and EFTA countries in the framework of the EEA places these countries in the first ring of the system of concentric circles. The EEA presents the deepest form of integration with the EU for non-members – a common market. By virtue of their membership in the EEA, the EFTA countries have access to the EU's Internal Market while remaining outside the EU. A common market envisions that in addition to the free flow of output and services, the integration between members is deepened by the free flow of factors of production, i.e. labour and capital. It also implies the participation of the EFTA countries in different EU policies and programmes. This arrangement works reasonably well at the technical level. The exclusion of certain sensitive sectors from the EEA (e.g. fisheries for Norway) makes this arrangement less favourable to the EFTA countries. Aside from that, one of the important drawbacks of the EEA arrangement is a very limited impact on the rules of the game. It evokes the EFTA countries to seek other alternatives to their relations with the EU.

Table 6. EFTA-EU European Economic Area

Legal Base	The EEA Agreement between the three EFTA states (Norway, Iceland and Liechtenstein) and the EU of May 1992. The agreement has a multilateral nature, i.e. it can 'speak with one voice' for the three EFTA states.
Coverage	Comprehensive. The scope of the EEA is determined by the existing EU market <i>acquis</i> when the EEA Agreement was signed, plus measures that have been subsequently adopted by the EU. The agreement also covers cooperation in other important areas such as research and development, education, social policy, the environment, consumer protection, statistics, tourism and culture.
Degree of harmonisation	As in the EU <i>acquis</i> , but EFTA is a two-pillar system. The Mutual Recognition Agreements (MRAs) concluded with Australia, New Zealand and Canada (Prot. 12) and a MRA with Switzerland (Annex I of the Vaduz Convention, 2002). Negotiations on an MRA with the US are ongoing.
Measures of non-traditional	In addition to the areas covered by the EEA Agreement, the EFTA states participate in Justice and Home Affairs (JHA) and the Common Foreign and Security Policy

⁶¹ Agreement in the form of an exchange of letters between the Community and each of the EFTA countries that grants tariff preferences under the GSP (Norway and Switzerland), providing that goods originating in Norway or Switzerland shall be treated on their arrival on the customs territory of the Community as goods with content of Community origin (reciprocal agreement) 201A0208(01).

integration	(CFSP).
Trade	The EFTA states shadowed agreements negotiated by the EU with third parties with the exclusion of agriculture (CEECs, Balkans and Mediterranean). At the multilateral level, the EFTA states are free to set their own tariff levels vis-à-vis other WTO members. The EFTA states are free to use their national commercial policy instruments (e.g. anti-dumping) against third countries.
Costs of compliance	The costs of compliance are similar to that of the EU member states (lower relative to other countries, such as Turkey or Central Eastern Europe).
Scope for national policy discretion	Formally wider scope but de facto little more than within the EU. The EU decides the policy and the EFTA states have to apply it.
Scope to influence 'rules of the game'	No influence over policy-making. The EFTA states have no right to participate in the decision-making process at the Council of Ministers level (although the ministers have been invited to informal Council meetings on an ad hoc basis in recent years). There is a possibility of policy-shaping through participation in Commission working groups and expert groups, and through other multi-level channels.
Effectiveness in terms of market access	Good, limited backlog in implementing the EU <i>acquis</i> .

Source: This table draws heavily on Emerson et al., Navigating by the Stars: Norway, the European Economic Area and the European Union, *CEPS Paperback book, 2002* and European Free Trade Association (2004), Free Movement of Goods, EFTA Fact Sheet, EFTA, Brussels, July 2004.

5.4.1 Lessons for Ukraine

The hypothetical participation of Ukraine in an EEA kind of arrangement would have the following pros and cons:

(-) First and foremost, the EEA requires deep regional integration, such as among the EFTA states. Unfortunately, Ukraine's direct neighbourhood is not homogenous. Russia, for example, promotes the idea of a Common European Economic Area, whereas Belarus has absolutely no desire to abandon Soviet-type central planning and Moldova's economy is rather small and its market is insignificant to Ukraine. Therefore an EEA-type of arrangement seems unlikely for Ukraine, as the region lacks the necessary preconditions for deeper integration.

(-) The scope of the EEA is extremely wide as it covers the free movement of goods, persons, services and capital. Around 700 product-related acts were initially included in the annexes to the EEA agreement during the negotiations.⁶² Moreover, the EEA is dynamic as the agreement envisions harmonisation of new directives, the number of which is constantly growing due to the 'moving target' nature of the *acquis*. Hence, its coverage is much wider than that of the Partnership and Cooperation Agreement. The adoption of all the *acquis* would be costly for Ukraine, as it is neither administratively nor economically ready to adopt the *acquis* without exclusions.

(-) Although the degree of harmonisation is high within the EEA, the risk of anti-dumping duties against products excluded from the agreement remains. Thus the EU preserves the right to introduce anti-dumping duties against salmon exports from Norway. This suggests that Ukraine should seek the inclusion of its sensitive sectors into a future agreement with the EU.

⁶² For detailed information on the scope of the European Economic Area, see Annex 3.

(-+) A limited scope of national policy discretion is possible under the EEA. However, despite having the right of reservation, i.e. not to adopt specific directives and regulations, no EFTA state has ever used this option. The possibility to opt out from specific directives and regulations would be beneficial for Ukraine, especially with regard to the expensive *acquis*.

(-+) The status of ‘decision-taker’ is not satisfactory for the EFTA states. Some of them, like Austria, Sweden and Finland, opted for full EU membership. Such an option (i.e. ‘decision-taker’) would be useful for Ukraine in the short and medium term; however, it would be less beneficial if the FTA were concluded. The EFTA states can participate in shaping policies through the Commission’s working groups. This would be a solution for Ukraine at the later stage. However, this would also require a shift in the EU’s position regarding the ‘all but institutions’ approach.

(+) An essential component of the enlarged Internal Market is close cooperation between the EFTA countries (including Switzerland) and the European standards organisations. Together with the Commission, the EFTA countries co-finance European standardisation work both through direct contributions and through the financing of technical standardisation work. This option is not feasible for Ukraine in the short-term. Ukraine must have proper institutions in place to cooperate, as well as an increased budget to be able to co-finance standardisation. However, cooperation in the form of joint technical standardisation projects would probably already be possible in the medium term.

(+-) Mutual recognition does not constitute a real problem for the EFTA states since they concluded equivalent agreements with the third parties to the EEA. However, Ukraine would not be able to automatically join the MRAs due to its diverging product market legislation. Extensive harmonisation is needed to overcome this discrepancy.

(+) The initial rules of origin for the EFTA states were determined by the 1972 EFTA-EEC Free Trade Agreement. They have been revised in various ways, with the EEA Agreement simplifying them even further. The EFTA has been instrumental in promoting the pan-European cumulation system, which has been in place since 1997. The extension of the European cumulation system to Ukraine should be explored.

Box 5. Common European rules of origin (European cumulation)

The EFTA countries and the EU had parallel free trade agreements (FTAs) with Central and East European partner countries. Although these agreements were largely identical, until 1997 there was no harmonisation of rules of origin. This restricted the ability of economic operators to use input from different partner countries, since doing so could mean that a finished product would lose preferential status and be subjected to customs duties. This matter was resolved with the introduction of the system of ‘European cumulation’, by which rules of origin are harmonised across 30 countries in Europe. One precondition for the functioning of the European cumulation system is that the rules of origin in the FTAs are substantially identical. This means that changes in the rules of origin have to be agreed on by all partner countries and implemented at the same time. A high level of cooperation among the partner countries is therefore required. European experts on rules of origin meet regularly in the informal ‘30 countries group’ to discuss developments and to co-ordinate actions.

The benefits from European cumulation are both economic and political. Cumulation implies improved market access, increased economic cooperation across Europe, enlarged sourcing possibilities for materials and products and improved possibilities for producers to realise economies of scale by organising their activities Europe-wide. The establishment of the system for European cumulation is especially felt in the textiles sector. Since 2001, the experts on rules of origin have been exploring the possibility of extending the European cumulation system to the Mediterranean partners.

Source: EFTA, *Free Movement of Goods*, EFTA Fact Sheet, Brussels, July 2004.

6. Conclusions and Recommendations

As a non-candidate country, Ukraine can choose the degree of compliance with EU market *acquis*. It can be selective both in prioritisation and timing. The form and the substance of the future EU-Ukraine FTA should be based on a pragmatic assessment of costs and benefits of the agreement for both sides. It is clear that the classic model of a free trade agreement will not have a strategic impact on either Ukraine or the EU, as it will only allow for a moderate improvement of market access. Given the experience of the MEDA countries and the recent changes in Ukraine, the EU could offer something deeper than the classic FTA to help the country improve its economic governance and to modify the economy.

The EU-Swiss Free Trade Area presents the most appropriate model in the long-term perspective, if/after Ukraine becomes a sustainable market economy and a certain degree of compliance with the *acquis* is ensured. The EU-Swiss model envisions cooperation in a significant number of areas. Moreover, the country is given a right to be selective in adopting the *acquis* and in harmonising its standards with that of the EU. The problems of rules of origin and mutual recognition are solved through the additional bilateral agreements. However, there are still some caveats. The selective approach of this model is to some extent illusory since the EU may use a ‘guillotine clause’ against the country. Moreover, the model neither safeguards the country against EU trade defence measures, nor does it provide a possibility for policy-shaping. In a possible trade-off between influence on EU policy-making and national policy sovereignty, Ukraine would be better off if the former is gained.

The EEA type of arrangement presents a less favourable/appropriate model for Ukraine. The scope of the EEA is too wide and the degree of compliance is too deep. Ukraine is neither administratively, nor economically ready to adopt the *acquis* without exclusions. Moreover this option is restricted, given Ukraine’s low degree of compliance with European standards. On the other hand, this option does not help solve the problem of anti-dumping measures in the sensitive spheres that are not covered by the EEA agreement (i.e. fisheries and agriculture). However, there are positive aspects of the EEA experience, which could be used in EU-Ukraine FTA negotiations. Among them are the right to policy-shaping by participation in the Commission’s working groups and cooperation in the form of joint technical standardisation projects. Today’s Ukraine is not in a position to use these options; however, after a certain degree of compliance with the EU’s *acquis*, it may become a feasible option.

The Customs Union model is difficult from political and economic perspectives. Politically, it would mean introducing the EU’s common external tariff for all third countries, starting with Russia. It would mean the end of free trade with Russia, which is not in Ukraine’s interest.

Although the creation of a free trade area with the MEDA countries was driven by security concerns, this experience could still be useful for Ukraine. The early stages of the EU-MEDA cooperation were riddled by inefficiencies. However, recent amendments agreed in the Valencia decision of 2002 include the moves towards a EuroMed Internal Market and direct prescriptions of bilateral Action Plans, which should lead to more effective outcomes. The FTA should have a positive development effect for the partner countries and a confidence-building effect for foreign investors. Regional integration would deepen through the intensification of regional trade. On the negative side, this model does not provide the partner states with a right to influence the EU policy-making process, leaving them as decision-takers as well. This can be acceptable for both the MEDA countries and Ukraine in the short- and medium-term perspective.

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Annex 1. List of Draft Laws to be adopted by Parliament

1. Draft Law on Incorporating Amendments to Article 1 of the ‘Law On Export Duty for Ferrous Metal Scrap’ (#7563)
2. Draft Law on Incorporating Amendments to the ‘Law On Export Duty for Live Cattle and Hide’ (#7567)
3. Draft Law on Incorporating Amendments to the ‘Law On State Regulation of Sugar Production and Sale’ (#7568)
4. Draft Law on Development and Use of Standards, Technical Regulations and Procedures of Conformity Assessment (#7586)
5. Draft Law on General Safety of Products (#7562)
6. Draft Law on Incorporating Amendments to the ‘Law On Quality and Security of Food Products and Raw Materials’ (#7587)
7. Draft Law on Incorporating Amendments to Several Laws of Ukraine (harmonization of Ukrainian legislation with WTO agreements in the sphere of sanitary and phyto-sanitary control) (#7595)
8. Draft Law on Tariff Quota for the Import of Cane-Sugar
9. Draft Law on Incorporating Amendments to Article 13 of the ‘Law on Television and Broadcasting’ (#7426)
10. Draft Law on Bar in Ukraine (#7051)
11. Draft Law on Incorporating Amendments to the ‘Law on Use of Special Measures towards Import to Ukraine’ (#7127)
12. Draft Law on Incorporating Amendments to the ‘Law on External Economic Activities’ (new version, #7126)
13. Draft Law on Quarantine for Plants
14. Draft Law on Incorporating Amendments to the ‘Law On Rates of Excise Duty on Alcohol Products’
15. Draft Law on Incorporating Amendments to the Customs Code of Ukraine
16. Draft Law on Incorporating Amendments to the ‘Law on Milk and Milk Products’
17. Draft Law on the Protection of Domestic Producers from Anti-Dumping Import (#7117)
18. Draft Law on Incorporating Amendments to Several Laws on Taxation of Agricultural Enterprises and Social Protection of their Workers

Annex 2. Commission’s Proposal for EU Services Directive⁶³

The **objective** of the Directive is to establish a legal framework that will make it easier for service providers to become established in other Member States, and to facilitate the free movement of services across the EU. The Directive seeks to offer service providers and recipients the legal certainty they require exercising these two fundamental freedoms enshrined in the Treaty.

The three pillars of the Directive

Eliminating obstacles to the Freedom of Establishment	Abolishing barriers to the Free Movement of Services	Establishing Mutual Trust between Member States
Administrative simplification	Country of origin principle	Harmonisation of legislation
Simplification of authorisation procedures	Right of recipients	Stronger mutual assistance
Prohibition of restrictive legal requirements	Assistance to recipients	Promoting the quality of services
Assessment of certain other legal requirements	Assumption of health care costs	Codes of Conduct at Community level
	Posting of workers	

Coverage:

The proposal covers all economic service activities except those for which specific exclusions or derogations are provided. The Directive only applies to providers established in a Member State. The proposed Directive applies to a large variety of services within the EU, including, but not limited to:

- Professional services such as consulting, architecture, engineering or legal advice; business services such as management consulting, certification and testing, maintenance, facilities management and security services, advertising services, employment agencies or commercial agents;
- Services which are provided to both business and consumers, such as legal or fiscal advice, architectural services, real estate agents, construction services, distributive trades, travel agents, charity shops, organisation of trade fairs and exhibitions and car rental;
- Services provided to consumers such as tourist guides, entertainment-related services (including audio-visual services, sports centres and amusement parks), health services and personal domestic services, such as assistance for the elderly.

The Directive **does not include** (Article 2(2)):

- Services provided directly by public authorities not for remuneration, in fulfilment of their social, cultural, educational or legal obligations;
- Certain services where specific initiatives are already in place to complete the Internal Market, which include:

⁶³ Source: http://europa.eu.int/comm/internal_market/services/services-dir/index_en.htm.

- I. Taxation, although Articles 14 and 16 of the Directive apply to taxation measures unless those measures are covered by an EC measure on taxation harmonisation;
- II. Financial services, as these are already covered by the Financial Services Action Plan, which is currently being implemented;
- III. Electronic communications services and networks as far they are already covered in the 'telecommunications package' adopted in 2002³;
- IV. Transport services, to the extent that they are already regulated by other Community instruments based on Article 71 and 80(2) of the EC Treaty⁴; and
- V. Activities covered by Article 45 of the EC Treaty, which expressly states that the chapter on the freedom of establishment and the free movement of services does not apply to those activities which are connected, even occasionally, with the exercise of official authority.

Annex 3. Scope of the European Economic Area (EEA)

Policy area	Number of directives in the EEA <i>acquis</i>
Technical barriers to trade	486
Other trade in goods	13
Veterinary and related measures	235
Free movement of persons	71
Free movement of capital	1
Financial services	53
Information technology and audiovisual	22
Transport	70
Social (health and safety, labour law and equal rights)	50
Consumer protection	12
Environment (air, water and waste)	43
Public procurement	9
Company law	12
State aids	3
Statistics	9
TOTAL	1089

Source: Abstracted from Emerson et al., Navigating by the Stars: Norway, the European Economic Area and

Annex 4. Structure of the EU's Free Trade Agreements with Selected Developing Countries⁶⁴

	Egypt	Morocco	South Africa
Rationale			
EU	Security	Security	Reinforce democracy Regional hub
Partner	Maintain preferences. Lock-in reforms. Attract FDI.	Maintain preferences. Lock-in reforms. Attract FDI.	Improve access to EU markets. Maintain preferences. Lock-in reforms. Attract FDI.
Transitional Period			
EU	Immediate	Immediate	10 years
Partner	12/15 years	12/15 years	12 years
Coverage Industrial			
EU	All	All	Almost all, by 2006
Partner	All, > half by year 4, and weighted on most protected	All, and weighted on highest tariffs	87%, and end-weighted
Coverage Agriculture			
EU	Approx. 60+% of imports, entry prices, plus preferences with tariff quotas		
Partner	Very limited; some duty reductions within tariff quotas	Very limited; some duty reductions within tariff quotas	Substantial; some wines subject to tariff quotas
Rules of Origin			
EU Rules. Bilateral cumulation with EU. Derogations can be requested.			
	Part MEDA* cumulation an objective		Full SACU** cumulation
Safeguards			
	Standard EU clause for both parties + transitional arrangements for partners		
Anti-dumping	Standard WTO rules		
Competition Rules	Outlaws collusion/abuse of dominant position of enterprises that distorts competition in trade.		Each retain own rules. Cooperation+EU assistance
State Aids	Must not distort competition in trade between EU and partner, but are permissible for public or policy objectives (EU Article 92).		
Rights of Establishment and Services	GATS*** plus possibility of further liberalisation		
Capital Movement	Capital relating to direct investment plus interest profits and dividends can move freely		
Standards	Aim of reducing differences (especially SPS****) and mutual recognition		

* MEDA The principal financial instrument of the European Union for the implementation of the Euro-Mediterranean Partnership.

** SACU South African Customs Union

*** GATS General Agreement on Trade in Services

**** SPS Sanitary and Phyto-sanitary Measures

⁶⁴ McQueen, 'The EU's Free-Trade Agreements with Developing Countries'.

Annex 5. Glossary of Terms

<i>Acquis</i>	<i>Acquis Communautaire</i> (Community legislation)
ACAA	Agreement on Conformity Assessment and Acceptance of Industrial products
AP	Action Plan
CEECs	Central and Eastern European countries
CEFIC	Conseil Européen des Fédérations de l'Industrie Chimique
CEFTA	Central European Free Trade Agreement
CET	Common External Tariff
CU	Customs Union
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Agreement
EIR	Integrated Economic Region
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Initiative
ERT	European Round Table of Industrialists
EU	European Union
FDI	Foreign direct investment
FSU	Former Soviet Union countries
FTA	Free Trade Agreement
FSAP	Financial Sector Assessment Programme
GATS	General Agreement on Trade in Services
GPS	General System of Preferences
ISPA	Instrument for Structural Policies for Pre-Accession
Meda	Community assistance programme for the Mediterranean countries
MES	Market Economy Status
MRA	Mutual Recognition Agreement
MRP	Mutual Recognition Principle
NIS	Newly Independent States (Armenia, Azerbaijan, Belarus, Georgia, Turkmenistan, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Ukraine, Uzbekistan)
PCA	Partnership and Cooperation Agreement
Phare	Community assistance programme for the Central European candidate countries
PTA	Preferential Trade Agreement
SACU	South African Customs Union
SAPARD	Special Accession Programme for Agriculture and Rural Development
SPS	Sanitary and Phyto-sanitary Measures
Tacis	Community Technical Assistance programme for the Commonwealth of Independent States
TAIEX	Technical Assistance Information Exchange Office
TBT	Technical barriers to trade
TRIPS	WTO Agreement on Intellectual Property
UNICE	Union of Industrial and Employers' Confederations of Europe
WTO	World Trade Organisation

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