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The EU-Ukraine FTA: Plus or minus?

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A Deep Free Trade Agreement (FTA+) between Ukraine and the EU is part of the Association Agreement that the two sides are currently negotiating. The "deep" here refers to the fact that both the EU and Ukraine want to underpin free trade in the classical sense by bringing Ukraine's regulatory base in line with the EU acquis in trade-related areas such as state aid, intellectual property rights, public procurement and so on. How likely is it that a Deep Free Trade Agreement will be signed and can we expect Ukraine to press ahead with its regulatory convergence? If the negotiations produce real results, how will they affect Ukraine and the EU? And, finally, how might the Association Agreement with FTA+ pave the way for a deeper relationship between Ukraine and the EU?

Negotiations on the FTA+ are still ongoing. Although information about the course of these talks and their current state is scarce, it is clear that the FTA+ is very much alive and ticking and has the potential to increase the EU's transformative power in Ukraine.

The ABCs of FTA+

The Deep Free Trade Agreement is part of an Association Agreement that will replace the current Partnership and Cooperation Agreement (PCA) between Ukraine and the EU. The other three parts of the Association Agreement cover a) political dialog and foreign and security policy, b) justice, freedom and security, and c) economic and sectoral cooperation. While Ukraine and the EU began negotiations on these three aspects back in March 2007, talks on the FTA+ were only launched after Ukraine's WTO membership was ratified in February 2008.

The FTA+ between Ukraine and the EU is different from classic free trade agreements, as the two sides will not merely discuss changes in tariffs and quotas to improve conditions for mutual market access. The major goal of the FTA+ is to achieve regulatory convergence, that is, the harmonization of Ukrainian legislation with the EU *acquis communautaire*.

In the first documents on the European Neighborhood Policy (ENP), the EU still offered Ukraine and all other ENP countries "a full stake in the internal market." In return, ENP partners were expected to follow the example of the members of the European Economic Area (EEA) and to take on large parts of the *acquis* that are relevant for the regulation of the EU's Internal Market. In 2006, the EU began to back away from this "carrot." Instead, EU documents stressed a longer-term vision of an economic community emerging between the EU and ENP partners and anticipated that ENP countries would selectively adopt relevant parts of the EU *acquis*.

Dances with the *Acquis*

On one hand, this process can be interpreted as backtracking. Selective harmonization rather than full adoption of the *acquis* could also offer those Ukrainian businesses that are closely linked to domestic politics opportunities for "cherry-picking," that is, electing to converge regulations only in those areas of the *acquis* that serve their private business interests. Although negotiators report that FTA+ talks are still happening at a strictly technical level, the process is likely to become more politicized as soon as Ukraine's business community begins to show interest in the process prior to the ratification of the agreement by the Ukrainian legislature. Whether this will result in additional amendments or revisions in the text remains to be seen.

On the other hand, selective harmonization can also be looked on as a more pragmatic approach, since Ukraine is not a candidate country. Given that Ukraine has weaker administrative capacities and incentives than EU candidates, it makes little sense, for instance, for the country to fully take on the costly EU *acquis* on the environment. First of all, this is not a prerequisite for signing an FTA+. Secondly, Ukraine would not have access to EU structural funds to ease the cost of harmonization with the environmental *acquis.* Yet these incentives played an important role in inducing, legitimizing and stabilizing change in one-time EU candidate countries from Central and Eastern Europe.

Even with selective harmonization, however, the range of areas that need to be negotiated in the Association Agreement is very broad (see Table 1). Nevertheless, some duplication between economic and sectoral cooperation and the FTA+ exist, since negotiations on the FTA+ began nearly a year later. In terms of cooperation, both sides have agreed to include several annexes covering most areas. These annexes refer to particular EC Directives that Ukraine's lawmakers need to take on and to specific transition periods during which the harmonization needs to take place. Similar annexes are also planned in the FTA+, but it is still subject to discussion between the two sides as to how to link the two documents.

Table 1: Areas of negotiation for EU-Ukraine Association Agreement

Economic and Sectoral Cooperation	FTA+
Company law	Trade in goods (Trade Defense Instrument and tariffs/tariff barriers to trade)
Sports	Trade and sustainable development
Tourism	Rules of origin
Management of public finances	Services
Health policy	Intellectual property rights (incl. geographical indications)
Energy, including nuclear energy	Trade facilitation and customs
Environmental cooperation	Public procurement
Industrial and commercial policy	Competition (anti-trust and state aid)
Cross-border and regional cooperation	Sanitary and phytosanitary standards
Education	
Training and youth	
Culture	
Research and technological development	
Macro-economic cooperation	
Social cooperation	
Mining and metals	
Agriculture and rural development	
Transport and audio-visual policy	
Taxation	
Statistics	
Consumer protection	
Information society and space	
Civil society	
Financial markets	
Fisheries and maritime issues	

Signing the dotted line

Despite President Viktor Yushchenko's hope that at least the political part of the Association Agreement might be signed at the EU-Ukraine Summit on 4 December 2009, the EU has made clear that it will sign the Agreement only when all aspects are agreed. Unlike Ukraine's President, who is interested in concluding the Agreement prior to the Presidential election scheduled for January 2010, neither the EU nor Ukraine's negotiators want to rush, preferring to conclude a detailed and comprehensive agreement.[1] More recently, even President Yushchenko has begun to approach the conclusion of the Association Agreement more realistically.[2]

According to the 2nd joint EU-Ukraine Progress Report, all chapters of the political part of the Agreement were provisionally closed in June 2008, while the chapters on illegal employment, the movement of people, and admission rules still need to be discussed in the part on justice, freedom and security. The parts on economic and sectoral cooperation, and particularly on the FTA+, are complex and here negotiations still need time. In the cooperation part, 19 out of 26 chapters could be provisionally closed. Talks on the FTA+ are still in their initial phase.

During the recent 8th round of negotiations in early October 2009, the chapter on customs reform and intellectual property rights in the FTA+ was ready to be provisionally closed.[3] The chapter on anti-trust is progressing, while issues like public procurement, sanitary and phytosanitary standards (SPS) and tariffs and quotas will still be subject to intense debate. The next round of negotiations is scheduled for December 2009, with two more rounds planned for March and May 2010.

The end of negotiations between Ukraine and the EU is still open since neither the European nor the Ukrainian negotiators commit to a specific date. In any case, some provisions of the Agreement, mainly those related to the FTA+ and to the institutional framework, are likely to enter into force provisionally once the EU institutions and Ukraine have notified each other of the completion of the adoption procedures. In the case of the EU-Chile Association Agreement, provisional adoption took place within a couple of months. In Ukraine, this process could be delayed, if the unstable situation in the Verkhovna Rada does not end. After that, the enactment of the Association Agreement is likely to take two or three years after the official conclusion of negotiations, based on the EU-Chile Agreement experience. This is because the legislatures of 27 EU member countries have to ratify the Agreement before it can enter into force.

What's in the FTA+ for the EU?

The EU has certainly an interest in bringing Ukraine closer, as it wants to create a stable "ring of friends" in its neighborhood.[4] As to enlargement, some members, such as Germany, France, Spain, the Netherlands, and Belgium, argue that the EU "lacks absorption capacities" to offer the strongest carrot to Ukraine, that is, prospects of EU membership and a full stake in the EU Internal Market. Instead, the EU is offering a smaller carrot: an Association Agreement including FTA+, at the cost of slower reforms in Ukraine than in EU candidates.

It is obvious that the EU negotiators of the Association Agreement, especially of the FTA+, do not see Ukraine as a potential member. The EU does not expect Ukraine to commit itself to adopt the full *acquis.* For instance, it is Ukraine's choice to harmonize its national legislation with the EC Directives on Waste Management, as this step is not necessary to finalize the FTA+. In contrast, the EU negotiators of the FTA+ certainly have an interest in improving conditions for their businesses in Ukraine. Here, they expect the Ukrainian side to demonstrate strong commitment to legal harmonization prior to

1 "Is there no chance of negotiating a Free Trade Zone prior to the Ukraine-EU Summit?" (in Russian), UNIAN, 10 October 2009.

2 "Viktor Yushchenko retreats to necessary positions" (in Russian), Kommersant, 16 October 2009.

3 "Next round of EU-Ukraine negotiations on FTA to be held on 7–11 December 2009," Press Release, Delegation of the European Commission to Ukraine, 12 October 2009.

4 Romano Prodi, "A Wider Europe: A proximity policy as the key to stability," speech delivered at the Sixth ECSA World Conference, Brussels, 5 and 6 December 2002.

the conclusion of the Agreement in areas like intellectual property rights, state aid and public procurement, as well as non-tariff barriers to trade such as technical standards.

In terms of tariffs and quotas, the EU negotiators will most likely not offer comprehensive concessions for Ukraine's agricultural imports. Even though this is one of the most important issues for the Ukrainian side, the EU will continue to protect its own farmers. Recent protests in front of the European Commission in Brussels by EU dairy farmers against the gradual elimination of protectionist measures have shown how politically charged this topic is in Europe.

EU concessions regarding tariffs and quotas are certainly not being traded against Ukrainian concessions in regulatory convergence in a "tit for tat" style. According to one EU official, European business is not pushing the European Commission to conclude the FTA+ with Ukraine as soon as possible, as was the case during FTA negotiations with South Korea. While EU business generally supports an FTA+ with Ukraine, the country's political instability and poor rankings on business climate or regulatory environment do not offer the most attractive destination for investments.

Support on the home front

Ukraine's Ministries

For public consumption, official Ukraine supports domestic reforms to bring the country's legislation in line with EU requirements, since Ukrainian law calls for a legal approximation to the EU *acquis.*[5] However, real efforts to promote harmonization have been weak in recent years. Despite the assistance of foreign and Ukrainian experts from USAID, the EU and the International Finance Corporation (IFC) in drafting new legislation according to European and/or international requirements, the outcome has been frustrating in many cases due to internal resistance. Bills submitted to the Verkhovna Rada tended to comply only partly or not at all with the *acquis*. The Laws on standardization, on assurance of conformity assessment (2001) and on food safety and quality (2005) serve as just a few examples.

Resistance from Derzhspozhyvstandart, Ukraine's consumer standards body, meant that the two bills on technical regulation submitted over to the Rada in 2001, as well as subsequent amendments prepared for the Rada in 2007, continued to treat standards as mandatory. The EU, by contrast, defines standards as voluntary. Furthermore, the bills and their amendments did not call for the restructuring of Derzhspozhyvstandart. To date, this body handles standardization, certification and conformity assessment, although EC law calls for these tasks to be distributed across several agencies in order to prevent conflicts of interests.

As far as Ukraine's Law on food safety and quality is concerned, USAID experts advised the Ministries of Health and Agriculture to call for the mandatory use of the Hazard Analysis and Critical Control Point (HACCP) principles that define the EU's approach to food safety control. This would have been a decisive step towards improving the chances of Ukrainian farm exports being given access to the EU Internal Market. Again, resistance from the line ministries obstructed this. As a result, this Law calls for voluntary application of HACCP and does not obligate state inspectors and producers to bring local food safety standards more in line with EU and international requirements, according to a recent IFC report.

The Verkhovna Rada

Generally speaking, there is consensus among Ukraine's leading political forces that EU integration is a strategic choice for the country. Yet very few politicians are ready to give up their local interests for the sake of better rules of the game for all, based on European standards.

The pro-presidential Nasha Ukraina—Narodna Samooborona (NUNS) bloc is probably the most consistent force, when it comes to supporting

[5] In 2004, the "National Program for the Approximation of Ukraine's Legislation to that of the European Union" passed into law, requiring the conformity of Ukrainian bills with the EU *acquis*.

Ukraine's EU integration, even though the bloc is increasingly divided into a faction of reliable Yushchenko supporters and a pro-Tymoshenko faction. The position of the Bloc of Yulia Tymoshenko (BYT) in the Verkhovna Rada is not always consistent with the government policy of Premier Tymoshenko, their leader. Although the Tymoshenko Government is running negotiations on the EU-Ukraine FTA+ and generally supports EU integration, in March 2009, the BYT faction in the Rada supported the adoption of a law that introduced a temporary 13% import duty for a range of products, including meat, textiles, some motor vehicles and home appliances. Later, the Cabinet of Ministers abolished the surcharge for these products, except for refrigerators and motor vehicles. On 6 September 2009, the remaining surcharge expired. The law clearly deviated from Ukraine's commitments in WTO and put the Government in a difficult situation with the EU.

The Party of the Regions (PR) is divided in its support of the FTA+ due to sometimes conflicting interests internally. On one hand, PR represents the interests of big industrial holdings like System Capital Management, which is owned by party member Rinat Akhmetov. These kinds of business groups are certainly interested in capitalizing their assets on international markets and support the improved conditions for Ukrainian exports and foreign investment in Ukraine that would follow approximation to the *acquis*. On the other hand, PR represents the interests of the "red directors" from Eastern and Southern Ukraine. Their industries, such as machine-building, will suffer from higher competition and reduced state subsidies if Ukraine switches to EU practice.

In 2007, the Verkhovna Rada demonstrated its generally strong support for Ukraine's EU choice when 399 out of 450 deputies across all factions voted in favor of a Resolution "On the start of negotiations between Ukraine and the EU on a new basic agreement." The Rada expressed its preference to conclude a legally-binding agreement that would lead to Ukrainian participation in the Single Market in the medium term and EU membership in the long run. The Rada also committed itself to harmonizing legislation to the EU *acquis*.

On the ground, however, the situation is different. Despite all the proclaimed support, the Verkhovna Rada is an equally strong obstacle to the harmonization with EU laws as are major elements in the executive branch:

- In 2004, the Verkhovna Rada rejected the Bill "On State Aid," which would have introduced EU standards.

- In 2007, amendments to the Law "On the Protection of Economic Competition," which also sought compliance with the EU *acquis* on state aid, also failed in the Rada.

- In 2008, the Verkhovna Rada rejected amendments intended to make the Laws on standardization and conformity assessment more compliant with EU legislation.

- For almost a decade, the Verkhovna Rada hindered the adoption of a Joint Stock Company Law that would increase the transparency of companies and strengthen the rights of minority shareholders in line with international practice and EC Directives.[6] Ukraine was the last country in the CIS to adopt such a law, when the Rada finally overcame long-lasting resistance in September 2008.

Still, opposition to bills intended to increase the level of compliance with the EU *acquis* is not necessarily a sign of anti-EU attitudes. Rather, close ties between business and politics often prevent the adoption of specific legislation, as the case with state aid reforms suggests. Other laws, such as the ones on technical regulation, fail to be adopted due to political in-fighting among different camps that are unable to form a stable coalition.

[6] For a long time, EU Corporate Governance issues most often depended on voluntary codes or national laws and regulations. Only parts of corporate governance issues fell within the scope of Community law, such as company law and financial services. Due to a number of EU corporate scandals in 2003, the European Commission recognized the need to regulate this issue at the Union level. In 2007, the EC Directive on shareholder rights (Directive 2007/36/EC) was adopted by the European Parliament and the Council.

Desperately seeking conditionality

Against the background of strong domestic resistance towards concrete support of Ukraine's legal approximation to the EU *acquis*, it is not surprising that the nucleus of Ukraine's pro-EU forces, namely, parts of the Ministry of Economy and the State Department of Legal Approximation (SDLA) and the Ministry of Foreign Affairs, is hoping to increase conditionality in the Association Agreement.

Experience with the PCA and the ENP Action Plan has shown that loosely-defined goals and timeframes have allowed Ukraine's officials to offer lip service and do little. A binding, clear and credible agreement will put pressure on Ukraine's Government and legislature. To this end, Ukraine's approximation commitments will be included in annexes to the Agreement as lists of EC Directives to be fully or partly harmonized within a specific period of time. Since the EU *acquis* is also subject to change, Ukraine's desire to include references to EC Directives in the Agreement will create some legal problems for the EU side. Still, its negotiators support the Ukrainians' request for stronger conditionality, as they understand quite well that the EU is needed as an external anchor for domestic reforms.[7]

Following the usual practice of Association Agreements between the EU and its partners, the new agreement with Ukraine differs from the older PCA in terms of institutional innovations. The Association Agreement introduces the possibility of binding decisions by a Joint Council. While the areas in which the Joint Council could take such decisions will be defined towards the end of the negotiations, it is likely that the approach will resemble the WTO dispute settlement process.

Mutually beneficial liberalization

How will the two sides benefit from further liberalization of EU-Ukraine trade relations and reforms to Ukraine's economic governance through regulatory convergence with the EU *acquis*?

[7] Interview with EU official, October 2009.

Tariffs and quotas

EU-Ukraine trade relations are already quite liberalized. After its accession to WTO in 2008, Ukraine reduced its tariff rates for many agricultural and food products (meat and dairy products, processed foods, spirits and alcoholic beverages, and so on) and some finished industrial products (some pharmaceuticals, cars, farm machinery, IT products, medical equipment, and so on). European firms benefited from this, since the EU mainly exports machinery, transport equipment, chemicals, textiles and clothing, and agricultural products to Ukraine.

For its part, the EU has been liberalizing its markets to Ukrainian commodities since the early 1990s. In 1993, Ukraine became a beneficiary of the EU's General System of Preferences (GSP). As a consequence, the import of some key Ukrainian export commodities, like chemicals and vegetable oils, has been liberalized. But many other products that constitute Ukraine's core export commodities, such as iron and steel, grain, seeds, fruits, and plants, fish products, have not been granted GSP benefits. Trade in iron and steel was only liberalized after Ukraine joined WTO. The EU eliminated its export quotas on rolled metal, which was the main export-boosting factor in Ukraine's WTO accession.[8]

However, exports of farm products to the EU are still strongly restricted through high tariffs and quotas. Thus, the liberalization of agricultural trade is one of the most critical issues in the FTA+ negotiations. Given that reliable information on offers regarding quotas and tariffs is currently not accessible, respective numbers, which were recently published by Kommersant, have to be treated carefully. If correct, the EU offer would be well below Ukraine's expectations: a quota of 70,000 tonnes for corn imports out of an annual harvest of 7mn t and a quota of 40,000 t on refined sugar of a total of some 1.5mn t that are likely to be refined in 2009.[9]

[8] Veronika Movchan, "Ukraine and the WTO: One year on," World Finance Review, September 2009.

[9] "Negative Associations: Right now, the EU is not prepared to accept Ukraine 'as is'" (in Russian), Kommersant, 168, 5 October 2009.

The situation in other areas of the farm sector, such as meat and dairy, is not easy, either. The EU market will remain completely closed for Ukrainian products in these two sub-sectors, as long as they do not meet EU food quality and safety standards. Following a request by Ukraine's State Department of Veterinary Medicine, the European Commission's Food and Veterinary Office (FVO) inspected Ukrainian dairy and meat plants in 2008 and 2009 and confirmed the lack of compliance. Once Ukrainian dairy and meat producers meet EU standards, they will be able to export. Even though the EU will certainly introduce quotas to restrict the amount of Ukrainian exports, the Russian case shows that harmonization with the EU SPS requirements can prompt the opening of the highly-protected EU dairy market. Several Russian dairy plants now comply with EU food safety and quality standards and have received permission to export to the EU.

Costs and benefits of regulatory convergence

The FTA+ offers a chance to improve Ukraine's agricultural export potential by adopting EU SPS requirements within the new Agreement. The more strongly the Ukrainian side commits itself to regulatory convergence in this area—and the more serious the implementation—, the more difficult it will be for the EU to continue protecting its markets in the future. This means that Ukraine should negotiate a schedule for the gradual opening of the EU market as the country raises its standards to EU levels.

Despite positive effects on the competitiveness of Ukrainian food products, the adoption of EU food safety and quality standards will require Ukraine to restructure its agricultural market and this will have attached social costs. Similar developments in EU candidate countries like Poland suggest that major food producers find it relatively easy to meet EU requirements due to economies of scale. Small producers will, instead, be crowded out of the market.[10] For instance, Ukraine's harmonization with EU SPS requirements is likely to have a strong impact on the domestic dairy sector: rural households rather than commercial farms produce the lion's share, 80%, of Ukraine's raw milk. These families, especially elderly pensioners, strongly depend on the production of milk as an additional source of income. Yet they will find it difficult to meet EU requirements as they have no economies of scale. This means that transition periods and structural support programs for the most affected sectors are needed to mitigate the negative impact and support commercial transformation.

The commitment on regulatory convergence in other areas, such as state aid and public procurement, will also produce high short-term costs for Ukraine:

- Convergence with EU state aid rules will affect Ukrainian industries like machinery, coal mining and agriculture, all of which receive state subsidies or tax breaks. The adoption of EU practices requires a change in the relationship between public and private players. This will be difficult, as the owners of large enterprises have considerable political power in Ukraine. At the same time, the current state aid regime supports too many dysfunctional companies and does not stimulate them to increase efficiency. Of course, the EU does not exclude the possibility of state aid to specific companies and sectors or regions with high unemployment, provided that the selection process is transparent and fair and does not distort competition. Most EU state aid is, however, channeled for environmental purposes and energy conservation, R&D, and SME development. Getting in line with the structure of EU state aid would help Ukraine decrease its energy consumption and spur economic development through scientific innovation.

- The existing public procurement system in Ukraine is corrupt, opaque and inefficient. To be sure, adjustment in this area will make it more difficult for Ukrainian firms to win public contracts since more transparency will also simplify access for foreign firms. To what extent Ukrainian firms will benefit from easier access to EU tenders depends on their competitiveness. Still, more competition on Ukraine's public procurement market should reduce corruption. Moreover, it should enable the Ukrainian government to offer better public services to its citizens at lower cost.

[10] Elizabeth Dunn, "Trojan Pig: Paradoxes of food safety regulation," Environment and Planning, 35 (8), 2003, pp. 1493–1511.

In short, reforms in areas like state aid and public procurement will be good for Ukraine and its economy, as they will improve the investment climate, reduce opportunities for corruption, and improve the quality of public services. According to some estimates, improved institutions and better governance could add 20-30% to GDP in the long term.[11]

Conclusion: More commitment all around

Negotiations on a Deep Free Trade Agreement between Ukraine and the EU are showing considerable progress in areas like customs reforms, intellectual property rights and anti-trust legislation. Still, the FTA's comprehensiveness and its real impact on Ukraine and the EU remain to be seen. The fact that the Ukrainian negotiators are asking for stronger conditionality is a good sign. For its part, the EU is demonstrating commitment to serve as an external anchor for domestic reform. In contrast to the EU-Ukraine PCA and other bilateral documents, the negotiators appear determined to establish clearer guidelines and timeframes for domestic reform and Ukraine's rapprochement with the EU. The Association Agreement including the FTA+ has thus the potential of bringing Ukraine closer to the EU.

To exploit this potential, both Ukraine and the EU will have to make stronger commitments, since Ukraine's regulatory convergence with EU rules will not only have positive effects for Ukraine's investment climate and overall economic situation. It will also impose high short-term adaptation costs on certain interest groups within the country.

Given this, **the EU** will have to offer some incentives for domestic reform that could have positive effects for Ukrainian producers in the short-term. On one hand, a further reduction in tariffs against Ukraine's current core export commodities, mainly agriculture, is needed as well as an increase in respective import quotas to the EU. On the other, the EU should signal its willingness to decrease protectionist measures regarding the imports of Ukraine's food products as soon as those meet EU food quality and safety standards. Last but not least, the European Commission should provide more targeted assistance to domestic public and private actors and scrutinize the implementation of Ukraine's commitments.

Ukraine must raise commitment at home to convergence with EU norms and reform of economic governance beyond the negotiating team. At the same time, there is a strong need for real public debate to prevent opposition to the FTA+ from Ukraine's lawmakers, bureaucrats and businesses.

Given the upcoming Presidential election, Ukrainian politicians are understandably reluctant to discuss the costs and benefits of the FTA+. This topic will not show up in the platforms of the majority of candidates, as it is not likely to bring more votes. But if local politicians want to regain the trust of Ukrainian voters that they lost in the aftermath of the Orange Revolution, they should look beyond January 2010 and start building more Europe in Ukraine.

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[11] UEPLAC, Aide Memoire — Background issues and possible implications resulting from implementation of the future EU-Ukraine Association Agreement and Free Trade as its core component, Kyiv, 2009.

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