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Implementing Deep Free Trade between EU and Ukraine – Time for a new approach

Julia Langbein

In December 2011, the European Union (EU) and Ukraine completed their negotiations on an Association Agreement (AA), including a Deep and Comprehensive Free Trade Agreement (DCFTA). The DCFTA does not only foresee the reduction of custom tariffs but seeks to foster regulatory convergence through which Ukraine is expected to unilaterally converge its national regulatory practices and government arrangements to the EU model in a number of areas such as technical standards, food safety, state aid, and company law. Up to now, the EU did not sign the AA as a reaction to the deteriorating political rights and the rule of law, exemplified by the increasing politicization of Ukraine's judiciary system during the trail against ex-Prime Minister Yulia Timoshenko. It is in the hands of the Ukrainian government to change the domestic situation so that the AA and the DCFTA can be signed. However, once the DCFTA will be set in force, the EU is well advised not to leave Ukraine alone with the challenge to implement all its provisions. The EU needs to develop a new approach to ensure the successful implementation of the agreement and to maximize the effectiveness of the EU's impact on regulatory convergence in Ukraine. It is necessary for the EU to flank the incentive of market access with capacity-building measures that do not predominantly target state authorities but also increase regulatory capacities of private stakeholders such as firms and business associations.

In the current policy debate about the European Neighbourhood Policy (ENP), the EU has been repeatedly criticized for its limited commitment to promote greater political and economic development in its eastern and southern neighbourhood by strengthening cooperation with local partners in civil society, the economic sphere and amongst the state bureaucracy. So far, Ukraine's progress with regard to the implementation of European standards and rules varies greatly across policy fields. In areas where convergence comes at high costs for key domestic stakeholders, preference for "business as usual" practices prevails. Further, public authorities and private actors like firms or associations often lack capacities to set, monitor and enforce European norms and standards.

The EU can make use of two tools to overcome implementation problems resulting from weak domestic incentives and regulatory capacities in Ukraine and other neighbours. First, in the absence of membership conditionality, the EU can exert conditionality towards its neighbours at the policy or sectoral level. In this sense, access to the EU single market is the strongest incentive to increase support among policy makers and private stakeholders in the neighbourhood countries for regulatory convergence in trade-related policy fields. Second, the European Commission can invest in assistance such as twinning projects or technical assistance projects to diversify domestic demand for policy reforms and to increase local capacities for adopting and implementing EU rules.

However, in-depth analysis of Ukraine's policy reforms in areas like technical regulation, which concerns the setting of standards for a wide range of industrial products, reveals that the EU does not effectively use available policy tools to increase domestic support among and capacities of public and private stakeholders for regulatory convergence. By 2011, Ukraine has only selectively adopted and implemented European rules and standards concerning technical regulation. The lack of reforms in an area like technical regulation will undermine the free movement of goods as envisioned in the DCFTA. By contrast, donors like the United States Agency for International Development (USAID) and the International Finance Corporation (IFC) in Ukraine employ available policy tools in a more efficient way to foster convergence with European and international norms concerning shareholders' rights. As of today, Ukraine achieved comparatively comprehensive convergence in this area, particularly with regard to rule adoption and the establishment of regulatory institutions needed to enforce shareholders' rights. While the aim of the subsequent analysis is not to rank the degree of success of different donors on the basis of two case studies, the brief comparison unravels shortcomings in the way the EU applies available policy tools.

The limits of market access and state support

In the area of technical regulation the Ukrainian state standardization body (DSSU) as the monopolistic regulator retains a vested interest in the status quo. This is not surprising since EU legislation would force that regulator to share its power with other public authorities and private certifiers. To be sure, European experts have been serving as legal advisors for the DSSU since the early 2000s. These experts certainly helped a minority of reformers within the authority to challenge its monopoly through the establishment of the National Accreditation Agency of Ukraine (NAAU) in 2002 and various legislative initiatives.

The DSSU's leadership can yet rely on powerful private stakeholders, i.e. the owners of big plants producing heavy machinery, in its effort to forestall more encompassing reforms. Policy-specific conditionality applied by the EU in the case of technical regulation has not altered the cost-benefit calculation of Ukrainian producers of heavy machinery. In 1993, the EU began to offer lower import tariffs for those Ukrainian machinery products that conform with European technical standards through the Generalised System of Preferences (GSP). However, Ukrainian producers fear market competition from EU firms, realizing that Ukrainian heavy machinery lacks competitive advantages on the EU market. Producers of heavy machinery are powerful political players owing to their strong representation in the Ukrainian parliament. In the context of Ukraine's clientelistic state-business relations, these producers managed to block major legislative initiatives that sought to make Ukraine's technical regulation more compliant with EU law in 2001 and 2008. They also prevent the drafting of much needed secondary legislation for laws that were adopted in 2010 and challenge the regulatory monopoly of the DSSU.

Concurrently, the opening of the EU market sufficed to increase incentives of small and medium-sized producers to apply European standards. They produce low value added products such as parts and components of machinery that enjoy a greater competitive advantage on the EU market than Ukrainian heavy machinery. Further, the production costs for meeting European norms and standards for parts and components are considerably lower than for heavy machinery. Moreover, small and medium producers of parts and components have an interest in achieving regulatory convergence in technical regulation since they suffer most from the corrupt Ukrainian system of technical regulation controlled by the DSSU. However, these pro-reformers lack the resources and political power to make their claims.

While EU technical assistance created opportunities for lesson-learning among parts of the Ukrainian standardization body DSSU, the EU did not launch capacity-building projects to empower reform-minded stakeholders among Ukrainian machinery producers. In addition, the opening of the EU market does not sufficiently increase incentives for producers of heavy machinery to invest in technological upgrading. As a result, parts of Ukraine's legal framework conformed to EU rules and practices with many inconsistencies, and the required institutional framework for enforcing technical standards is only partly in place.

Getting it right

Unlike the EU, the IFC and USAID have actively promoted regulatory convergence in the field of shareholders' rights, including the transparent distribution of information concerning shareholders' meetings, the publication of financial reports or the right to sell shares in case of mismanagement. The protection of shareholders' rights has been and remains to be an important requirement in order to get listed on European and international stock exchanges. Yet, the presence of rewards in the form of market access did not foster immediate support for convergence with European and international shareholders' rights among all Ukrainian stakeholders.

During the 1990s, the privatization of state-owned assets dominated large portions of Ukraine's political and economic life. Back then, the benefits of maintaining messy ownership structures and weak protection of shareholders outweighed the reward of market access for most Ukrainian businessmen who were primarily interested in acquiring assets rather than capitalizing on them at international stock exchanges. Only Ukrainian brokers and dealers had an interest in improving the image of the market in order to attract more capitalization amongst Ukrainian companies as well as foreign investment. During the 1990s, these potential reformers were however without any strong political representation to make their voice heard.

Assistance provided by USAID and the IFC gradually empowered reformers and diversified domestic demand for convergence towards international and European rules and norms in the field of shareholders' rights. By helping to establish the *Persha Fondova Torghova Systema* (PFTS) association in 1996, a self-regulatory organization for security traders in Ukraine, the donors helped to improve the organization of pro-reform forces. That same year, USAID provided the PFTS Association with technical assistance to create the PFTS trading system, which was the first market-owned stock exchange in Ukraine. The donors also helped to establish the Ukrainian Securities Commission as early as 1996 to install a regulatory authority that would adopt, monitor and enforce shareholders' rights.

Once the distribution of property rights in Ukraine ceased by the early 2000s, Ukrainian firms, including big business groups that were strongly represented in the Ukrainian parliament, became increasingly susceptible to policy-specific conditionality as they wanted to capitalize their assets on European and international financial markets. The IFC reacted to this growing demand by setting up various programs to teach Ukrainian firms about the protection of shareholders' rights as an important condition for accessing foreign financial markets. Furthermore, with the support of the IFC and USAID, the PFTS and the Securities Commission used the growing support among Ukrainian businesses to generate a JSC Law that was compliant with EU legislation. The pro-reform coalition of private and public regulators, which was created and empowered by the IFC and USAID in the mid-1990s, thus anchored increasing market pressures by Ukrainian companies to enter Western capital markets.

Recommendations: A new approach for the DCFTA

Insights from the dynamics driving policy reforms in Ukraine's technical standards and shareholders' rights show that the European Commission should reconsider its approach to support Ukraine with the implementation of DCFTA provisions, and should take the following considerations on board:

- Promote regulatory convergence by flanking economic incentives, i.e. access to the EU Single Market, with capacity-building measures for those state authorities and private stakeholders (e.g. firms and sectoral business associations) whose support is required for the adoption and implementation of EU rules in a particular policy field/sector.
- Identify those state authorities and private stakeholders whose support is needed for the adoption and implementation of EU rules in a particular policy field/sector before planning assistance projects.
- Analyze the cost-benefit analysis of those public and private stakeholders who are affected by regulatory convergence in a particular policy field/sector and develop tailor-made assistance projects that help increase the incentives and capacities of these actors.
- Encourage the European Bank for Reconstruction and Development (EBRD) or other donors to introduce a credit program for the upgrading of Ukraine's production plants and to tie credits to convergence with European standards.
- Provide support for the founding of business associations representing those producers for whom convergence is beneficial.