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The DCFTA's Impact on the Modernisation of Ukraine's Economy

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To make full use of the Deep and Comprehensive Free Trade Area with the EU, it will not be enough for Ukraine to implement EU norms and technical standards. The Ukrainian government should create transparent and stable regulations and simplify the business environment. In this respect, legislative approximation in sectors covered by the DCFTA will be necessary. At the same time, it will be essential that the EU financial support provided to Ukraine is spent effectively to minimise, at least partially, the high cost of modernisation.

One of the objectives of the EU-Ukraine Association Agreement (AA) is to create a Deep and Comprehensive Free Trade Area (DCFTA). It provides for liberalisation of trade between both parties as well as harmonisation of norms, technical standards and regulations in trade-related sectors. The DCFTA, which was signed in June 2014, has been provisionally applied since 1 January 2016, and will remain in effect until the EU-Ukraine Association Agreement enters into force. However, this may take several years, in part because voters in the Netherlands in a referendum rejected the AA, so the date of its entry into force is now difficult to predict.[1]

Importance of the DCFTA. The approximation of Ukrainian law to the EU is the essence of the DCFTA. It has been estimated that by implementing the DCFTA, Ukraine would adopt as much as 60% of the EU's *acquis communautaire.* As a result, the country would have the opportunity to become part of an area with common economic principles. The adoption and effective application of the DCFTA would make it possible to reduce investment risk and attract foreign direct investment, which in turn would allow for the modernisation of particular sectors of Ukraine's economy. The effects of the DCFTA's implementation would be visible, especially in such sectors as banking, telecommunications, and postal and courier services, since legislative approximation leads to their integration with the EU's services market. In addition, Ukraine's geographic proximity to the EU means it could become an attractive location for the production of goods destined for the bloc's internal market. The country's western regions (oblasts) will benefit the most from the changes, for example, the recent development of vehicle parts manufacturing. In April, 2016, the Japanese company Fujikura opened a factory in the Lviv region. German manufacturers such as Leoni and Kromberg & Shubert also plan to increase investment in the country. Those three companies alone plan to spend millions of euros in Ukraine in the next five years and will create more than 15,000 new jobs.

In the longer term, the implementation of the DCFTA would also benefit exporters from the EU and Ukraine. Under the deal, EU and Ukraine are to eliminate 98.1% and 99.1% of their trade tariffs, respectively. Non-tariff barriers to trade also should be eliminated, e.g., import quotas (although there will be some exceptions in the agricultural sector, for example). As a consequence, some estimates show these changes would result in trade savings between them of €700 million annually.

Moreover, Ukraine should adopt a number of the EU's norms and technical regulations, which is a condition for providing it access to the bloc's internal market. Its regulations are recognized by the U.S., Canada, Japan, South Korea and others. Thus, their adoption also would allow Ukrainian exporters simpler access to some non-European markets.

[1] For more about the possible delay of the entry into force of the EU-Ukraine Association Agreement, see: D. Szeligowski, "The Netherlands Referendum on the EU-Ukraine Association Agreement: What Is the Effect of the "No" Vote?", *PISM Bulletin*, no. 27 (877), 8 April 2016.

However, even with these changes it is unlikely that the DCFTA will lead to a significant increase in bilateral trade between the EU and Ukraine in the short term. Trade tariffs on goods exported from the EU to Ukraine were already rather low and averaged 5%. On the other hand, from April 2014 to the end of 2015, Ukrainian exporters benefited from the EU's Autonomous Trade Preferences, which eliminated import duties on most industrial and agricultural goods as well as foresaw the application of duty-free tariff quotas for a number of agricultural products. The volume of trade will also be limited by the temporary capital and currency restrictions put in place in Ukraine to protect its balance of payments.

Necessary Steps. Whether Ukraine makes full use of the DCFTA depends on whether it creates a stable, transparent and effective business environment. Therefore, legislative approximation of sectors covered by the DCFTA should be the priority. Although the AA has not yet entered into force, it is in Ukraine's best interest to start adopting the EU regulations as soon as possible. Given that the institutional administrative capacity of Ukraine is relatively low, harmonisation should proceed gradually, sector by sector.

Implementing the EU's competition principles, intellectual property law, and customs regulations will be essential. The competition principles provide for the complete elimination of direct budget subsidies for state-owned enterprises (funds which comprise as much as 10% of Ukraine's GDP and enrich its oligarchs). Additional funds will then be available to support public and private enterprises in adjusting to the EU's norms and technical regulations. The intellectual property law allows for innovative development and technology transfers, which constitute the basis for economic modernisation. The effective protection of intellectual property is of utmost significance to Ukraine's IT sector in particular because it accounts for as much as 3% of GDP. Positive results would also flow from new customs regulations because the current ones are obstacles to export. For example, a World Bank report showed that filling out the document required to export goods from Ukraine to third markets takes twenty times longer than in most developed OECD countries.

In parallel with these changes, simplifying the business environment will be necessary, especially reducing the excessive cost and time required for obtaining building permission and electricity service. Changes need to be introduced to the business-unfriendly tax system, particularly elimination of its tax police force, which *de facto* extort bribes. Also, within the broader reform of the judicial system it will be important to improve the country's courts that deal with business disputes. Ukraine ranks 83rd in the "Doing Business" ranking. Among all European countries, only Albania ranks lower.

In the longer-term perspective, increasing the number of border crossings will be key. This would allow for less time to cross the border, which means lower export costs. Ukraine's border with EU countries stretches for 1,390km (Poland, Slovakia, Hungary, Romania), but there are only about 20 border crossings. In comparison, Poland, before its accession to the EU, had as many as 30 crossing with Germany alone (along a 467km border).

EU Support. Implementing the AA's provisions will require significant funds from Ukraine, in the short to medium term in particular. Although benefits should be expected in the long term, the effective use of EU funds already granted to Ukraine will be essential in order to minimise the high cost of modernisation. To avoid spending them ineffectively, priority should be given to a limited number of actions as well as to building the institutional capacity of the state administration. First, special programmes dedicated to technical and legislative support and "twinning" between EU and Ukraine's public institutions will facilitate legislative approximation. In this regard, Ukraine may draw on the experience of the Central European countries that underwent a similar process of harmonisation on their road to the European Union. Second, long-term support programmes for the private sector, mostly for small and medium-sized enterprises, will allow them to adjust to the EU's norms and technical standards. Third, to make full use of its geographic proximity to the EU internal market, infrastructure projects such as the development of transport networks and preparation of investment areas will be important.

Funds for modernisation are coming from, first of all, the European Investment Bank (the preliminary allocation for Ukraine is $3 billion in 2017–2020) as well as from the European Neighbourhood Instrument (in 2016–2020, Ukraine may receive up to $170–180 million in grants annually). Moreover, Ukraine's government has a €100 million credit line from the Polish government at its disposal to use for such needs as the development and modernisation of infrastructure on its border with Poland. Also, Ukraine will benefit from EU cross-border cooperation programmes in 2014–2020, such as "CBC Poland-Belarus-Ukraine," "CBC Hungary-Slovakia-Romania-Ukraine," as well as "CBC Romania-Ukraine," all of which aim to improve the accessibility of regions in these countries and to develop trans-border transport and communication networks.