

Date: 24.2.2009

REF: SIPU/JMWEN ASS. 02

The negotiation of the Free Trade Area Plus agreement and possible implications for SIDA programming

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(Reference should be made to paper 12 which already dealt to some extent with the Free Trade Area Plus as part of the Association Agreement)

The Association Agreement with Ukraine is innovative in the way it deals with trade. The treaty will include a 'free trade area plus' agreement. The idea of the FTA+ comes out of a series of reflections on the future of trade policy, led by the EU Trade Commissioner.¹ With import tariffs now so low throughout the world, traditional trade agreements, which lead to tariff, or quasi-tariff reductions, tend to lose their significance. While lowering tariff barriers is still of interest to the European Union and its partners, especially those in middle income and developing countries, the real motivation for new trade agreements in the neighbourhood must be the reduction or elimination of non-tariff barriers and the spreading of European regulation. The aim of the FTA+ agreements is therefore to combine conventional trade liberalising measures with the obligation of the partner to introduce some EU regulation. It is not totally clear whether there should be a conditional relationship between the two areas; should the implementation of trade concessions for instance be dependent on the third country implementing a certain amount of EU regulation?

What is Deep Free Trade

¹ See for instance: European Commission, 'Global Europe, Competing in the World' COM (2006) 567, 4/10/2006

The Association Agreement with Ukraine will include a 'deep and comprehensive free trade area' agreement according to the declarations of the European Council. Such agreements aim to eliminate the majority of non-tariff barriers to trade through persuading third parties to adopt and implement EU regulation necessary for the creation and management of the Union's internal market. As this regulation is progressively adopted and implemented, the EU can take steps to facilitate access by third-party enterprises to the internal market of the Union.

The 'deep' in this term refers to the fact that free trade will be underpinned by agreement in trade related areas such as competition policy and public procurement, which are essential for the realisation, not simply of 'free trade' in the classical sense, but for real economic integration.

Comprehensive refers to the scope of the agreement in terms of products covered. It is envisaged that the NEA will establish a free trade area covering a substantial part of trade in goods and services, with specific derogatory regimes applying to limited sensitive goods and services.

The EU points out that in the longer term this process of deep integration could lead to Ukraine being perfectly integrated into the internal market in a similar way that the members of the European Economic Area are integrated. This would mean that Ukrainian producers could sell their products or services on the EU market on an equal footing with EU companies. This is a useful indication of the EU's openness to economic integration, in spite of its apparent current opposition to accession.

However there are of course a very large number of practical problems in this approach, although the proposal itself is a very positive sign to the Ukrainian economy. The technical problems will be immense and can only be solved over the course of decades rather than years. Not only will large numbers of European Union laws and policies need to be implemented, but new institutions including inspectorates and regulators will have to be developed and existing institutions changed and in some cases scrapped. The judiciary will also need to be retrained to deal with this complete change in the legal landscape of Ukraine. There is, of course, a democratic dilemma in this approach as well, in that Ukraine would be obliged to implement a whole raft of existing and new legislation with no input into the making of these new regulations and directives – as is the case presently with, for example, Norway. However, Norway remains outside of the Union of its own volition. Ukraine does not. Without a membership perspective at any stage, this may be harder for Ukrainian politicians and the Ukrainian public to accept.

The negotiation of deep free trade is clearly extremely complicated. It is made somewhat more complicated by the fact that the negotiation is taking place in two separate but overlapping parts. The Association Agreement proper,

including political dialogue, justice and home affairs, institutions and cooperation policies, is being negotiated separately from the Free Trade part. However the cooperation chapters are not simply about sectoral cooperation, but also include considerable detail about the regulation which Ukraine is expected to adopt in the coming years. To some extent this regulation affects the development of deep free trade.

The main chapters of the agreement will not be radically different from earlier Association Agreements with the countries of Central and Eastern Europe. What are likely to be different are the dispute settlement and safeguard clauses.

The trade articles

The pure trade articles may well be similar to previous negotiations. This will be a preferential agreement and will conform to WTO rules.

The essential elements are an agreement on standstill; that is to say agreement on a date after which tariffs on both sides may not be raised except perhaps in extraordinary situations which are regulated by the agreement itself.

The two sides will then negotiate on the tariffs. Both sides have agreed that 95% of trade between them should be tariff-free, but this still leaves an important element to be negotiated. This will presumably be an asymmetric agreement, in which the EU tariffs will fall deeper and faster than Ukrainian ones. At the present stage however the EU is still waiting for the tariff offer to come from Kyiv, before which the negotiation cannot start.

Trade in agricultural products is again likely to be an area of difficult negotiations, especially as the brief period of rising agricultural prices seems to be coming to an end for many products. The EU is probably slightly less protectionist on agriculture than it was when the first Association Agreements with central and eastern European countries were negotiated at the beginning of the 1990s, but it still remains difficult to penetrate the protectionist barriers. Yet agriculture should be an important area of economic growth and development for rural Ukraine in the years to come.

There may well be other specific products on which one of the parties or both may not be able to agree to the elimination of tariffs or other measures. In the current crisis, free trade in the traditional sensitive products (steel, textiles, heavy chemicals and perhaps cars) may well be difficult to negotiate.

Finally there is the difficult question of rules of origin, which are necessary in trade agreements to avoid exporters from third countries exporting to the EU

via Ukraine. This is an important element of the negotiation because eventually it will allow Ukraine to join the Pan-Euro-Mediterranean Cumulation Zone, making it easier for some Ukrainian producers to export to the EU under the preferential trade agreement. However adopting appropriate rules of origin to enter this zone and enjoy first bilateral cumulation and then diagonal cumulation will require significant institutional change.

The internal market acquis

Adjustment to the narrow internal market acquis, specifically the areas of accreditation, conformity assessment and the questions of standards have been negotiated in an Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA). However the terms of this agreement still have to be implemented and this will clearly be rather difficult. Above all it involves the creation or reform of institutions such as standardisation, accreditation, and conformity assessment bodies, metrology organisations and market surveillance authorities. Reforming what is today essentially a continuation of the system which existed during the period of central planning is difficult.

Trade in services

In the context of its WTO accession, Ukraine has already liberalised its service sector and regulation governing it. Certain restrictions remain and are sanctioned by the WTO, but these are relatively limited in scope and many of them run out after a transitional period. It is however likely that the EU will push Ukraine further to adopt EU regulation which governs the services sector. An example here might be in transport services, where if the EU opens its market to Ukrainian operators, these will have a competitive advantage if they are not required to meet the same regulations that operators within the EU meet.

Trade facilitation

Customs procedures in Ukraine, frequently combined with low-level corruption, impose major costs on exporters and importers. It would be therefore of considerable interest both to Ukrainian traders and those in the EU, if Ukraine was to adopt EU customs rules and procedures. This would involve some institutional change, a large amount of training, a considerable increase in cooperation between Ukrainian customs and those in the EU and a certain amount of physical investment in frontier infrastructure.

Sanitary and phyto-sanitary regulation

In joining the WTO, Ukraine adopted the necessary regulation and implemented an SPS reform programme. In adopting WTO compatible norms in SPS, it is also adopted a considerable number of those standards applying in the EU. Nevertheless, to approximate totally to EU regulation will be a long process in Ukraine, involving a considerable amount of investment on the ground, institutional change and training. The agreement with Ukraine will therefore aim at progressive approximation of domestic regulation to that of the EU combined with a gradual opening of various sectoral markets in the EU to Ukrainian producers.

Agricultural exports are of course potentially one of the main benefits to Ukraine from its integration with the European Union. The various agricultural sectors are obviously affected differently by current regulation. The trade in cereals has only very light regulation. However trade in meat, meat products and milk is deeply affected by SPS regulation. In the future as Ukraine harmonises its regulation to that of the European Union, these sectors will undergo major structural change but will represent a strong chance for future growth of Ukrainian exports to the Union. The scale of the necessary changes can be assessed by looking at the changes which took place in the food sector in Poland prior to accession, where many meat factories and dairies were forced to close, while others which met the SPS regulation were able to expand rapidly.

Establishment and the Movement of Labour

It is probable that the EU will be prepared to offer Ukraine complete liberalisation of establishment in the agreement, while insisting on a similar treatment being offered to EU enterprises in Ukraine. It is possible however that a few exceptions to the general liberalisation may be agreed.

Linked to establishment is the question of the movement of key workers in parallel to the establishment of business. Here the EU has become much more prudent over the years of its experience of Association Agreements. In the early years, establishment was used as a form of free movement of workers. As the European Union shows no sign of being inclined to further opening of its labour market, beyond guaranteeing national treatment to workers who are legally resident, it will ensure, through the agreement, that only bona fide key workers are allowed to access the labour market in the EU.

Competition policy and state aids

While Ukraine does have a competition law which was passed in 1996 and which is largely based on EU regulation, it does not have a law on state aid. The Anti-Monopoly Committee of Ukraine has the role of regulating mergers,

dominant positions, fair competition and anti-competitive behaviour of the state authorities, the latter including state aid, procurement and price controls.

The way in which the competition law is implemented, and the role of the Anti-Monopoly committee and the extent of its real independence, will however give cause for some alarm in Brussels.

If we look at just one area like state aids, it is clear that adjustment to the EU rules on state aid will require a complete rethinking of policy by government. The EU definition of state aid is cast very widely to include areas such as special tax regimes, government guarantees given to individual companies or sectors, as well as the more easily understandable question of subsidies given to firms. Adjustment in this area will require legal and institutional changes as well as a complete change of practice in key government ministries and in the large enterprises, often owned by oligarchs, who have considerable political power in the current Ukrainian system.

In the Association Agreement, the European Union will certainly push for deadlines for the implementation of the main competition rules and for adjustment to EU state aids policy. With state aid in Ukraine going to special economic zones, technology parks, shipbuilding, aircraft, construction, coalmining and various other sectors, even if the negotiation is not so difficult, implementation will be.

Intellectual Property Rights

The European Union will negotiate for a similar level of IPR protection in Ukraine as applies in the EU itself. This was already the aim of the Partnership and Cooperation Agreement which entered into force in 1998. It will therefore concentrate on the implementation in Ukraine of EU regulation, which will include the recognition and protection of geographical indications.

Public procurement

Rules on public procurement have been a hotly contested area in Ukraine for many years, and the changes which were undertaken recently did not create a system less open to corruption. This is another area where it may be simpler to negotiate an agreement than it is subsequently to implement it.

The goal for the EU has been stated as 'progressive approximation with the EU procurement acquis'. It should therefore provide for 'mutual access on a national treatment basis to public procurement markets at national, regional and local level for public contracts and concessions in the traditional sector as well as in the field of utilities'. (EU Council negotiations mandate)

The Cooperation Articles in the Agreement and Regulatory Convergence

The **cooperation articles** in this agreement will be different from those in the earlier Association Agreements with central and eastern European states. In the latter the cooperation chapters were intended simply to mention key areas where the parties could co-operate but without any obligation to do so. In the Ukrainian agreement the cooperation chapters will also include annexes in which specific elements of EU regulation will be listed. As these articles include areas such as environment policy, transport, taxation, and agriculture and rural development, all of which are major regulatory areas in the *acquis*, the cooperation articles will take on an importance which they did not have in previous association agreements, except perhaps in Stabilisation and Association Agreements with the Western Balkans, which expressly aim at preparing accession of these countries to the Union.

It is here, rather than in the free trade agreement, that the scope of the legal harmonisation envisaged by the EU will be revealed. Naturally the wording of these articles will be crucial. If the wording suggests that the harmonisation is a requirement of the agreement, this is obviously very different from wording which requires simply best endeavours. However with both draftings, there will be a political obligation on Ukraine to implement the regulation which is listed in the annexes, even if there is no legal obligation.

Dispute settlement and safeguards

Such a deep and comprehensive agreement is certain to have a series of safeguard clauses, to ensure that in extraordinary circumstances the agreement may be put on one side in order to allow the affected partner to return to a more normal position. In extreme cases these safeguards may be introduced unilaterally.

However far more interesting than the standard safeguard clauses, will be the negotiation of dispute settlement clauses.

The member states of the European Union have become somewhat disillusioned by the poor implementation of some of the accession treaty articles in the new member states, notably in Bulgaria and Romania, and of the ENP Action Plan with Ukraine. If through the deep and comprehensive free trade area, the European Union is committed to opening the internal market to Ukrainian enterprises, it will therefore need to be absolutely sure that the terms of the agreements are being implemented by Ukraine. This will mean very strict monitoring of the implementation of the terms of the agreement and a possibility to freeze the opening of the internal market should parts of the EU *acquis*, having been adopted, not be implemented.

This of course raises the further dilemma of what to do if the two parties disagree about the judgement on the state of implementation of the *acquis*. It may well be that Ukraine considers the implementation to be working, while

on the European Union's side there is still doubt. In this case it will be necessary to have a dispute settlement regime which allows a judgement to be made, which is legally binding. Work is still going on on this important point.

Economic impacts

If this deep and comprehensive free trade area is successfully negotiated, it will mean enormous changes for Ukrainian business, even if a series of safeguard clauses and exceptions are included in the agreement.

In the medium term the overall impact on Ukraine's economy is bound to be extremely positive, as trade with the European Union increases and foreign direct investment flows back into Ukraine. However in the short term many businesses in Ukraine will be hit by higher costs and some will lose market share on their home market.²

Politically, this could be very dangerous for the development of relations between the two parties. It is therefore essential that the major business interests in Ukraine are convinced of the importance of EU integration in both their own businesses and for the economy as a whole. This may be tricky since it is possible that participation in the single market could be labelled as an alternative to EU accession or 'compensation prize' by some Ukrainian politicians for short-term political gain. Ukrainian businesses might also fear that without full membership of the Union their interests would be ignored by the EU when agreeing directives and regulations for the single market.

Implications for SIDA

The implications for SIDA assistance to Ukraine from the successful negotiation of a deep and comprehensive free trade agreement are naturally very wide.

The areas in which SIDA assistance could be decisive include the following:

- Technical assistance with both the transposition of EU regulation and its implementation across the whole scope of the free trade area agreement in those areas where Sweden has specific experience;
- Assistance in the creation of new institutions or the reform of existing institutions which are required in the process of integration with the EU;
- The training of staff required to operate tasks supporting the implementation of the free trade area;
- Specifically in the governance area, as suggested in a previous SIDA-JMWEN in paper, the development of improved coordination of Ukraine's European integration policy is absolutely essential. In

² ICPS Kyiv; Free trade between Ukraine and the EU: an impact assessment. Kyiv 2007.

particular, civil servants working on European integration-related dossiers need the assurance that their work can continue and progress can be made when the political situation in Ukraine is unstable.